MERGERS and ACQUISITIONS: PLANNING and ACTION

MERGERS and ACQUISITIONS: PLANNING and ACTION

A research study and report
prepared for the

FINANCIAL EXECUTIVES RESEARCH FOUNDATION

by

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Preface

The significance of mergers and acquisitions is recorded in the history of American business and reflected in the improvement of living standards throughout the world; yet business managements are constantly in search of methods to insure the profitability of business combinations, hence the reason for this further research authorized by the Officers and Trustees of Financial Executives Research Foundation in 1959.

While recognizing that much information had previously been written on specific aspects of this subject, the Research Foundation felt that there was a definite need for an authoritative work, which would be helpful to the business executive involved in planning and implementing a merger or acquisition. As initially conceived, the study was to result in a sample check list of required policy decisions, implementing mechanics and legal aspects and problems involved in business combinations. When the check list had been compiled and evaluated, it was clearly evident that, put to practical use by corporate financial executives, the study would have to be considerably expanded in many areas to include descriptive text which would enable a reader, with no previous experience in this area, to obtain a broad general knowledge of planning for a merger or acquisition, as well as the implementation process.

After discussions with many individuals expert in this field, the Board of Trustees approved the recommendation of the Research Director that Arthur D. Little Inc., Cambridge, Massachusetts, be authorized to develop a comprehensive manuscript on the subject of *Mergers and Acquisitions: Planning and Action.* Their long experience in this field, plus their facilities for research on specialized topics, made them uniquely qualified for this project

and the Trustees are impressed with and enthusiastic about the results of their efforts.

In addition to the work of Arthur D. Little Inc., our Foundation is indebted to Robert B. Wheelan, who compiled the basic check list and did much of the preliminary research work, and to the Review Panel which contributed many hours of time, thought and effort to insure the success of this project.

The Panel members, serving under the Chairmanship of Harold A. Ketchum, Vice President, International Latex Corporation, reviewed the initial check list and each of the subsequent drafts of the manuscript. They offered constructive suggestions at every stage of their review.

If this study sets the guidelines and points up the pitfalls for corporate financial executives involved in planning a merger or acquisition, the Foundation will have accomplished its purpose in undertaking this research project.

L. C. Guest, Jr., President
Financial Executives Research Foundation 1961-1962

Foreword

A fundamental relationship in the affairs of men equates opportunity with change. Nowhere has this been more forcibly demonstrated than in the history of business in the United States. Change provides opportunity for a new approach to product development, a different environment for the emergence of human talent, and a continuing opportunity for industry and commerce to become stronger and more creative. All these interactions of a dynamic business environment reflect our motivation for profit and personal satisfaction. Within the framework of law and the ethics of business conduct, we should utilize all our resources and methods to continue the evolution of improvement, creativity and viability.

We are pleased to have had the opportunity to collect pertinent information on one process of implementing change. Through this accumulation of the experiences of others, we hope to present a total view of the depths and importance of this kind of corporate action. In a world that daily grows smaller, more populated, more complex, corporations must look beyond conventional boundaries if they are to make the contributions for which society rewards them in the form of profit. A joining of units of strength, under proper circumstances, should be a desirable strategy in business.

James M. Gavin, President
Arthur D. Little, Inc.

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Introduction

The purpose of this book is to outline a rational approach to mergers and acquisitions, and to thus help the reader anticipate problems and minimize their adverse effects since adequate preparation should make it possible to deal quickly and thoroughly when an opportunity arises or is developed.

Mergers and acquisitions have played an important role in the growth of many of our leading corporations. Two-thirds of the 100 largest publicly held corporations in 1960 have made at least one important merger in their history, and most of these have made one or more acquisitions during their corporate life. Some firms are well known for merger and acquisition activities: U. S. Steel resulted from the consolidation of a number of smaller steel companies around the turn of the century; General Motors was formed during and just after World War I; General Dynamics assembled a number of defense and defense-related companies after World War II; and Textron was built through acquisition of textile firms and a number of companies in a variety of industries.

Many concerns, not well known for merger and acquisition activity, have, nevertheless, used this means for building their enterprise. For example, the Ford Motor Company acquired the assets of the Lincoln Motor Company in 1922 and in 1953 acquired the tractor and farm equipment assets of Dearborn Motors Corporation. In 1961 Ford joined the ranks of corporations involved in important mergers by purchasing the Philco Corporation

and two parts-manufacturing plants and certain other assets of the Electric Auto-Lite Company. It is probably safe to say that every firm of major proportions has, at one time or another, given at least passing consideration to merger and acquisition as a means of attaining corporate goals and objectives or as a means of taking advantage of an immediate opportunity.

While mergers and acquisitions have been a constant fixture in business life, the first real "wave" of them took place between 1886 and 1896. Three additional periods of unusually high activity are easily identified: 1898-1902, 1926-1930, and the post-World War II era. The early period was one of consolidation and horizontal diversification and saw the emergence of a few dominant companies in industries which were formerly characterized by a relatively large number of small enterprises. Some of the leading companies of today which emerged from these consolidations are Standard Oil of New Jersey, U. S. Steel, Bethlehem Steel, General Electric, International Harvester, American Tobacco, Eastman Kodak, Swift, and American Can. Many of these merger efforts were directed toward the control or dominance of markets. Social reaction led to the passage of the Sherman Act and the dissolution of certain consolidations, notably Standard Oil and American Tobacco which had achieved virtual monopoly in their respective fields.

The activity in the 1920's operated under somewhat different ground rules and saw the rise of holding companies which spanned a relatively broad range of related product lines. Among the important firms built during this period were Radio Corporation of America, Allied Chemical & Dye, American Cyanamid, National Dairy Products, General Foods, and Borg-Warner. Since World War II, the conglomerate approach has come into use again as exemplified by the actions of Textron, W. R. Grace, and American Machine & Foundry.

Merger activity has occurred at one time or another in all major industry segments. The extent of activity seems to have been great during periods of heightened business activity and the expansion of the economy, but whether this is casual or symptomatic is open to question. Analysis indicates that mergers in a given industry occur at a rapid rate when the industry is undergoing a period of rapid growth. This is not at all surprising since it has become

almost axiomatic that a company which does not in some way change its product mix and market emphasis over a period of time will decline in profitability. Most successful companies have remained so by participating in growth areas which are in some way related to their basic operation.

Underlying most successful mergers is the expected goal of increased value of the resulting combination compared with the value of each as a separate entity. Depending on conditions in an industry, a segment of an industry or the general economy, business combinations become more capable of results known as the familiar "together we can do better," or "2 plus 2 will give more than 4." The textile industry was and probably still is, in a condition of over-capacity which provides an opportunity for facilities, organization, finances, etc., to be pooled where unneeded resources can be liquidated with the result that profitability can be restored.

While some firms have had the good fortune to anticipate developments (or indeed to pioneer new fields) and thus develop from within, many companies have entered developing markets by merger and acquisition in order to save time and to assure significant participation during the growth period. For example: North American Aviation organized its Autonetics Division from within in order to participate in the military and space electronics fields in the early 1950's; Lockheed Aircraft obtained a stake in this area through the acquisition of Stavid Engineering; and, the Ford Motor Company followed suit by acquiring the Philco Corporation. Incidentally, in recent years a large share of the mergers and acquisitions has concerned companies in the electronics industry, one of the major growth segments of today's economy. These actions have involved not only mergers of small and medium-sized companies within the industry to create a stronger base for expansion and development, but have also involved acquisitions of firms active in developmental areas by companies whose operations are centered in the more mature segments of the electronics industry and by firms in apparently unrelated fields which have become relatively stable.

Sooner or later, most corporate managements will have to deal with the merger/acquisition question, either as a buyer or as a seller. Since merger/acquisition offers a means of implementing company objectives, particularly for the larger firms, any corporate

management should be familiar with the techniques and problems involved in weighing the merger or acquisition against alternative courses of action. Merger and acquisition is not an end in itself, but another method of realizing company objectives. As such, merger/acquisition should be approached in the light of the objectives and the over-all plans of the company.

Although smaller companies are more likely to be sellers they, too, should think through the subject in order to be properly prepared. The extent of familiarity with details will, of course, depend in large measure on the circumstances of the individual firm, but the general principles and major problem areas should be appreciated by all.

The first part of this book, "Planning," discusses factors to consider in order to provide a sound basis for considering a merger or acquisition, i.e., developing and defining company objectives; evaluating company resources, strengths, and limitations; and building an over-all long-range plan. These are assessments which any progressive management will make continually, whether contemplating merger/acquisition or not.

If merger/acquisition is to be carried out only as a means to employ capital, as in certain holding company programs, the evaluation of resources and the need for a forward plan based on existing strengths is not very important. However, most business enterprises are operating companies and must keep a balance among the operating functions. At a specific point in time the balance may be tipped toward a greater skill in manufacturing and a lesser skill in marketing, or toward a strength in operations with a weakness in financial structure. The problem is to make the right assessment and then to complement the strengths.

The specific steps necessary for embarking on a merger/acquisition program are discussed next—establishing criteria for the search and preliminary screening, preparing the initial presentation to the prospect, and preparing finances to expedite completion of the program.

The second part of this book, "Action," examines the techniques of search, approach and exploration, evaluation, and negotiation in considerable detail. The chapter, "Assimilation," reviews the

problems that most often follow a transaction. Although management cannot anticipate all the difficulties that arise during the period of assimilation, careful preparation can eliminate many of them and reduce the magnitude of others.

This book approaches the subject of merger/acquisition primarily from the standpoint of the buyer, i.e., a company engaged in a program of expansion that involves merger/acquisition. Much of what is said is equally applicable to the seller, and a number of problems faced by sellers are commented upon.

Finally, any merger/acquisition program must ultimately be the responsibility of top management in whom is vested the power to make decisions necessary to carry forward such an effort. Management can obtain invaluable assistance in carrying out the details of various aspects of a program from specialists, such as accountants, lawyers, and business consultants, who have had extensive experience in the professional disciplines involved and who are able to gather pertinent data, properly interpret them, and submit recommendations for management action. The advantages of supplementing management with outside specialists throughout all stages of an acquisition program, from setting corporate objectives to integration of the organizations, include:

1. Saving of executive time.
2. Introduction of an outside viewpoint.
3. Opportunity for investigation of prospect companies by revealing or withholding the client's name.
4. Familiarity with diversified procedures, markets and technologies.
5. Experience in negotiating under varied circumstances.
6. Expense saving over separate, permanent staffing to carry out a program.
7. Counsel with respect to the complex legal requirements.

A reasonably complete coverage of the principal elements involved in a merger or acquisition program for an industrial company is made in the sections which follow. While individual parts of the book may be reviewed separately, caution must be exercised when taking any section out of context. Merger or acquisition is only one route in a corporate diversification or growth program. Internal product, management or facility development is still the predominant course for corporate evolution.

Part I

Planning

Chapter I

Definition of Corporate Objectives

Careful definition of objectives is a vital primary step in all corporate planning whatever route of action is selected: internal growth through research and development; joint venture; or merger/acquisition. Because a merger or acquisition generally results in a substantial financial commitment at the time of consummation, extra emphasis is made in this study to encourage a definite understanding of objectives.

Corporate objectives, simple or complex, are the foundation for all future plans and their implementation because they provide a basis both for decision-making and for evaluating results. Since merger and acquisition often have a long-term impact on a company's operations, management should define objectives which will be valid for a maximum period of time. Nevertheless, the definition—and periodic review and revision—of corporate objectives is a continuing job since the environment in which a company operates, and the relative importance of various influences on its course of action, are constantly changing.

The nature of the ownership, whether widely held or individually owned, as well as the philosophies, capabilities, experiences, and motivations of directors and/or influential management will have a decided effect on whether an enterprise views the corporate goals as the quantitative measurement of equity value or whether other purposes for corporate existence will also be recognized and require both definition and a means of measurement. A predominant group of businesses look to a goal of a level, or rate of in-

crease, of return on investment (not complicated here as to means of measurement) as the only objective. They call the other constraints and policies as a means of controlling the actions to attain that single objective. Indian Head Mills, for example, has a brief, explicit objective of increasing the value of its common stock, with the various means to that end not to be confused as objectives in themselves. Experience has shown that other groups of business leaders who are involved in a profit-motivated enterprise (we are confining this treatise only to profit-oriented industry and commerce and not to philanthropic or public, non-profit organizations) view their objectives as composed of a parallel, although not equally weighted, set of aims. They may be motivated, for example, by a desire to excel in creative development for the public good, with a minimum profit goal as one necessary aim. Whatever the aspirations or methods of implementation, it is appropriate to establish the purpose, goals, policies, limitations or any other semantic description of desire and direction in order to initiate and control action.

Within the broad interpretation of objectives, we can characterize a program of merger/acquisition as having a high probability of success if decisions can be made on a forward plan with enough flexibility to change with new influences. The following sections should be reviewed as leading up to acquisition criteria and actions which follow. If an individual or company relies only on intuition, luck, or cold devotion to only one specific aim of the greatest possible profit (short-term, long-term, or average) the detail of considering objectives, resources, and developing a plan to reach the objectives is perhaps wasted energy. In this case, however, there is a greater probability of risk.

Although top management has the ultimate responsibility for defining and approving corporate objectives, all persons in a position to influence the company's operation should be encouraged to participate in their formulation to derive objectives which they can understand, and, hopefully, accept. Charles W. Percy of Bell & Howell has stated this principle as follows:

"We believe firmly that our business should be the expression of the ideas and objectives of our entire management group and, as far as humanly possible, of our employee group."

In another sense, a company will disintegrate if its objectives

do not allow associated individuals to pursue their interests and ambitions. Management thus has a two-fold task: to establish corporate objectives that yield benefits to the individuals associated with the company; and to motivate the same individuals to adopt personal goals that are compatible with the corporate objectives.

The following section discusses seven basic types of corporate objectives, and some of the problems associated with them. These seven major categories of corporate objectives are:

1. Financial
2. Product and marketing
3. Research, development, and engineering
4. Manufacturing
5. Personnel
6. Community relations
7. Corporate image

In general, corporate management will have a basis for its preliminary preparation of objectives through its inherent recognition of a variety of existing resources, skills, policies, preferences, and other internal and external influences. The formal process of analysis is an interplay of goals and capabilities which affect a dynamic set of objectives. The "hen or the egg" evolution has its counterpart in this interaction, but there is no need to make a strong point for which comes first and they may not be mutually exclusive. To establish objectives which will be more than "to improve stockholders' invested values," requires a practical awareness of some strengths and weaknesses. As the corporation then constructs its goals a review of resources will generally indicate the need to shore-up some deficiencies or to add skills, capital, or manufacturing facilities. All this process, taken within the constrictions of a time plan, can lead to the long-range plan in which acquisition or corporate reorganization is an appropriate road.

Financial: Profitability, a basic requirement, is usually put in terms of return on investment, and may specify a minimum, an average, and/or a goal to strive for under optimum business conditions or at some future date. For a company just starting in business or a company which finds itself in difficulties and is suffering losses, a time scale is particularly important. For example, the profitability objective might be stated as a break-even opera-

tion two years hence and a specific minimum return on investment within four years, or it might be put in terms of a payout period, i.e., recovery of the initial investment over a period of X years, or a cumulative percentage return within Y years.

As a measure of operating performance, return on investment is often stated in terms of before-tax-income on applied total assets or capital employed in the business. For measuring financial performance, after-tax return on net worth is frequently employed. From the stockholder's standpoint, earnings per share of common stock and/or dividends per share are useful bases.

But what return is to be set as the corporate goal, how is the return to be reached, and what will be the attitude toward balancing other objectives, policies, and methods as they may affect the primary goal of return on investment?

Some managements look to the leaders of their industry for appropriate targets. Others cause impossible demands on themselves by selecting rates which may exist for other industries at given times in their life cycles but which really have no basis for attainment since competition within their own industry, for example, may not allow gross margins sufficient to provide the return goal. During the last several years segments of the paper industry have been faced with overcapacity leading to lower margins. A corporation either in the paper industry, or wishing to enter, would be setting improbable goals by looking at performances in the cement, pharmaceutical, food, or other industries where the profits have been well above average. However, it is just this sort of condition which has caused some managements to reach to diversification through merger or acquisition as a way to increase return on investment and to attain other financial goals.

A profit objective stated in terms of net income on sales is generally of some use as an operating measure, and it may be the most useful and practical means in a low-investment business or a personal service business where almost all the profit is taken out in the form of commissions, bonuses, and incentives. In businesses which involve a substantial capital investment, the ratio of sales to investment may be relatively inflexible and is strongly influenced by competitive conditions.

Profit on sales is frequently a highly inaccurate tool for evaluating alternatives, particularly mergers and acquisitions outside the company's normal field of activity, because the profit on sales required to earn a given return on investment varies substantially from industry to industry. On the other hand, comparable data on income-to-sales ratios among companies in a given industry are often easier to obtain than return on investment information, and the definition of what constitutes the base against which income is measured is less subject to confusion. In such cases profit on sales can be a useful yardstick.

The rate of growth desired as well as the goals as to the size of the operation several years hence may be a financial objective since growth is, to a considerable degree, controlled by the availability of funds for investment in the enterprise and is dependent upon the way in which these funds are utilized. Financial growth objectives should be stated in terms of the total profit dollars desired and capital gains or equity appreciation.

Volume objectives such as total sales in dollars more properly belong under the area of marketing objectives. As a financial objective, volume objective is derivative in nature; that is, it is based on primary profit and return on investment objectives and assumptions as to financial relationships which will prevail. Therefore the stated volume objectives must be met in order to achieve the desired profitability.

In some entrepreneurial types of businesses, and under certain conditions, growth in the market value of the company may be of primary importance where the objective is to make a profit primarily through the sale of the enterprise within the foreseeable future.

Smaller companies particularly may formulate an objective as to the marketability of the stock. A closely held company whose stock is not traded should periodically review the desirability of creating a market for the stock in terms of the flexibility of investment needed by the owners, especially in connection with the retirement and estate problems as against the problems of maintaining control of the enterprise. The extent of distribution of the stock, i.e., number of stockholders, should be considered as a basis for plans and decisions regarding stock splits, new issues, ease of

implementing merger plans, communication with stockholders, etc.

Desired debt-to-equity ratios should be indicated, i.e., the leverage desired and the acceptable degree of risk in this area. The extent to which a company's operations are financed by loans is not always fully controllable and may depend on such things as business conditions, the state of the capital market, and interest rates. However, there is often wide latitude in the choice of debt-equity ratios; in smaller and medium-sized companies the strong prejudice against debt may have an important impact on expansion decisions.

Product and Marketing: The company should consider very carefully the types of products and services it provides, and intends to provide. A careful examination of existing circumstances will often point out that the products and services being offered are not compatible with future plans and thus do not provide a good basis for planning. Product and service objectives can be quite detailed, but should have a concise general theme.

Most product and service activity, however specialized, falls within some broader definition. The discipline of setting product and service objectives exposes a company to the problem of considering a broadening of the product line and the means by which this might be accomplished. For example, a manufacturer of lead acid batteries might have as an objective the manufacture of automotive starting, lighting, and ignition batteries. He might change this objective to the production of a full range of automotive and industrial lead acid batteries, and then further change it to the manufacture of many different kinds of batteries, including lead acid, alkaline, and dry cell. Similarly, a company specializing in wooden shingles might formulate the objective of offering a variety of roofing and siding materials and of providing installation service.

Product and service objectives may also be stated in terms of desired pricing and quality levels. Clearly, Rolls Royce and Volkswagen differ in this regard. Although both produce automobiles, one caters to the luxury market, building the very finest that is obtainable almost without regard to price, while the other strives to provide transportation of the best quality obtainable for a low

price. Many products must meet minimum quality standards in order to be saleable to all, and yet there is a considerable range in the quality of products which are sold. It is not always true that the minimum quality, lowest-priced product has the largest volume potential. In setting pricing and quality objectives, a shift from an established pattern can be hazardous, particularly if the change is made suddenly.

A company should define the types of markets and customers which it intends to serve. In making merger/acquisition decisions, the company should consider whether it will serve additional markets, compete with its customers, or offer additional products to the markets it is already serving. As with product and service objectives, market and customer objectives should have a general theme, but it may be spelled out in considerable detail.

The general statement of types of products and services and the statement of types of markets and customers can often be combined; for example, "the objective of this company is to produce specialty valves of the type required by steam power plants," or "the objective is to build advanced design submarines for the U. S. Navy," or "the objective is to manufacture safe, good-quality, educational toys for the three to seven year age group."

Companies often set objectives as to the share of market which should be attained. The market share objective can be stated as a percentage of the total industry volume or it can be stated in other terms. In a rapidly growing market, the percentage of total approach has particular validity when it is projected over a period of time and is used as a check point for making decisions concerning investment in additional capacity or withdrawal from the market. A company should develop its share-of-market objective before the market reaches maturity since it is much more difficult to change market-share goals after the market matures.

In setting market-share objectives, a firm must be very realistic about the prospects of achieving a major position in the face of strong or entrenched competition. Quite frequently, companies are hazy about "market," since a market may be defined in several ways and may be comprised of a number of identifiable segments in terms of customer groups, price ranges, etc. Incidentally, this question can be of considerable importance in antitrust delibera-

tions. In the cellophane case, Du Pont argued that cellophane was in active competition with a wide range of other flexible wraps and constituted less than 20% of all flexible packaging materials sales. The Department of Justice had charged that Du Pont accounted for approximately 75% of the sales of cellophane, and that it, therefore, had achieved a monopoly in violation of Section 2 of the Sherman Act. After due deliberation, the Court found that cellophane was not the market, since other flexible wrappings were reasonably interchangeable and, therefore, competitive.

In a comparatively cyclical industry, market share is often a better measure of performance than is volume, particularly in the short term. For example, a company which fails to maintain an existing market share in a period of rising sales may have great difficulty in regaining its former position in the future.

A firm may specify a market-share objective, rather than a percentage, as being sufficient to accomplish some purpose. In this instance, the market-share objective becomes a derivative objective as, "a market share sufficient to assure continuing distribution through leading department stores, operate at a profitable volume level, or assure recognition of the company in the market place." Sometimes market share is purposely restricted to a level well below that which is attainable in order to assure demand for the product and keep prices and profit margins up, or to maintain the scope of the operation within the management capabilities of its staff.

A company may have specific objectives as to distribution methods. Montgomery Ward was slow to abandon its policy of mail order distribution and introduce retail stores. Chrysler Corporation, for many years, sought to provide all its dealers with a low-priced line by dualing its Plymouth dealerships with its more expensive lines.

Distribution objectives should be examined very carefully to see whether they are reasonable and, indeed, whether they should be stated at all. They may be improper and actually be nothing more than a description of the means being used to implement other primary objectives. There is a tendency for distribution objectives to overlap with other objectives. For example, a company might wish to have its own field salesmen and specify an objective of at-

taining sufficient volume to support an employee sales organization in order to provide better service and control of the sales force since that had proven difficult, if not impossible, by selling through manufacturers' representatives. One company apparently had the objective of maintaining factory-owned branch offices and warehouses in key cities and became blinded to alternative distribution methods which could have resulted in substantial savings and increased profits.

Research, Development, and Engineering: Most companies today need the results of a research, development, and engineering effort in order to survive. Some firms place great emphasis on technical leadership, while others are content to be followers. The objectives should state the extent to which the company intends to carry on an R & D and engineering effort internally, and the nature of the effort, i.e., basic and/or applied research, product development, market research. Such objectives may also state whether the company intends to obtain or purchase R & D and engineering results in the form of license agreements, prototype designs, or contract research.

Some small companies do not have, and may not need, a formalized research and development program so long as that function is being performed in some manner and the company has access to its results. Certain types of operations may not require particular kinds of research and engineering; for example, a distribution company may not need product development or manufacturing engineering but may need product evaluation facilities and an extensive market research activity.

A company may properly set an objective specifying a level of effort, such as a minimum expenditure in dollars or percentage of profits. The objective may be particularly important in a rapidly moving industry, or in an industry which spends a substantial sum on basic research.

R & D objectives may indicate specific areas of effort such as development of a particular type of product or manufacturing process. It may be decided that this effort should be relatively narrow and directed primarily at bringing forth hardware, or the firm may decide to build a capability for cross licensing or a base for earning royalty income.

Objectives may indicate the addition of new capabilities which complement existing resources of the company. For example, a manufacturing job shop might decide to build a research and engineering capability in order to develop a line of proprietary products.

Manufacturing: Manufacturing objectives specify what a company will produce, and they establish basic policies governing make-or-buy decisions. For example, a firm that is primarily a manufacturing organization must form objectives that indicate whether it will manufacture at all, whether it will function primarily as an assembler or packager, or whether it will integrate backward towards raw materials or forward toward finished products and in what areas. In general, the objectives must identify the character of the company's manufacturing activities. Manufacturing objectives should also indicate whether the company intends to produce all or the bulk of its own requirements, or whether it intends to use its manufacturing facility as a control and purchase most of its requirements outside. The latter practice has been followed for some time by many of the U. S. Army Ordnance arsenals. Some electronics firms have followed this practice with respect to transformers to be used in their end products.

Sometimes it appears desirable to integrate not only to seek the usual operating control and advantages but to put surplus funds to work. An argument is occasionally advanced that the use of funds in integration can be invested at a lower rate of return than the general corporate objective. However, this may tie up funds which might be more advantageously used in a program of acquisition at a later date.

Consideration should be given to the question of the level of utilization of facilities. Some industries operate on a one-shift basis while others typically operate on a two- or three-shift basis, the textile industry being a good example of the latter. Certain types of continuous process operations, particularly in the chemical and petroleum industries, cannot be economically operated on an intermittent basis because of shutdown and startup costs; others, although flexible, may be governed by competitive pressures which require high utilization for profit. In some instances, the level of possible utilization is restricted by the availability of qualified labor. Here, a strong desire or need for high utilization may have

to be balanced against the desirability and economic feasibility of increased mechanization and the attendant reduction in quantity or skill levels of labor required.

Utilization objectives are a particularly thorny problem in cyclical industries such as machine tools and other specialty capital goods fields. In such industries the utilization objectives may result in compromises in the design of the plant and equipment to enable production, during depressed periods, of items other than the primary product line. Such compromises may result in less than optimum conditions for the production of the primary product but, nevertheless, may be more desirable over all. The utilization objectives can, in a sense, be derivative objectives. That is, achieving a particular profit level may require operation at a percentage of capacity different than would normally be the case because of other decisions which have been made and other relationships which have been established.

In establishing manufacturing objectives, some consideration should be given to inventory policies and desired delivery cycles. These questions are related to product and marketing objectives, such as product standardization and service considerations. Nevertheless, these questions bear on whether the company seeks to build products to order or to inventory, the length of runs or size of lots, and employment stability. Different objectives may be established for different products in the line. For example, the company may have an objective of being able to ship certain primary products within one week from receipt of order but may be willing to tolerate a four-week cycle on slower-moving items. Also related to marketing objectives is the question of whether or not the company will produce and market special designs and modifications of its standard products or whether it will subcontract special work.

In general, purchasing considerations also fall in the manufacturing area. Expansion of manufacturing, either for greater production of existing products or addition of new products, could conceivably result in significant purchasing economies by enabling the company to obtain volume discounts or to meet minimum purchase requirements of suppliers or potential suppliers. One purchasing objective might be to become a major or important customer of all key suppliers in order to assure a continuing supply

of needed items and control over the services provided by the supplier. This kind of an objective could, conceivably, affect make-or-buy decisions as well as the sources of supply selected.

Personnel: Personnel objectives should state the company's position on matters such as employment stability, personal security, fringe benefits, opportunity for advancement and improvement, wage levels, incentives and methods of compensation, overtime, ethical standards of conduct, and the degree to which lower echelons can have a voice in management and participate in management decisions. It is important to consider these quite carefully since a company's success is heavily dependent on people. Here also lies the greatest opportunity for leadership and effective implementation of the intangibles of motivation and morale. It is dangerous to state personnel objectives publicly without implementing them and/or demonstrating to the employees that they are stated sincerely. Since personnel objectives directly and vitally affect the individual employees, great care must be taken to explain exactly what the company has in mind. It is relatively easy for employees to develop misinterpretations and to become quite disillusioned by company action. Some personnel objectives should probably not be publicized since they would appear to be in opposition to the desires of the employees. Nevertheless they may be necessary in view of other situations and may be proper when viewed from the over-all standpoint of the survival of the company.

It is becoming increasingly important to have clearly defined personnel objectives because of the trend in the political climate and because the labor unions are becoming particularly vocal about what they think company personnel objectives ought to be. Most unions have established firm positions in bargaining for new contracts. Management should have a clear idea of its personnel objectives in order to avoid confusion and unnecessary concessions when bargaining with unions. Personnel objectives are important even in unorganized companies; established objectives can provide a basis for demonstrating to employees that union organization is unnecessary.

Since Federal and State laws, regulations, and welfare policies are increasingly having a direct effect on company operations, a firm should gain a clear understanding of the laws and regulations in order to avoid conflicting objectives. Unemployment compen-

sation laws and assessments levied against companies, minimum wage laws, fair employment practice laws, wage and hour laws governing overtime policies which can be implemented—these all have a bearing on company personnel objectives both in terms of pointing the direction of future trends and in imposing restraints on the company's freedom to act.

A firm should be aware of the conditions of the labor market in its own geographical locale in establishing personnel objectives, since these conditions can have an important bearing on the feasibility of implementing objectives. In a thin labor market, the company may not be able to afford objectives which encourage or result in high turnover. Local conditions are especially significant with respect to unskilled and semiskilled labor. For these, the company may be competing against unlike firms with different product lines and types of business activity. If it is to attract and hold the better workers, it must have competitive policies. For example, a company in a highly cyclical business would have difficulty operating in a community having several plants with stable employment, assuming comparable wage rates. Similarly, a company which must pay low wages because of competitive conditions in its markets would find it difficult to operate in a high-wage town.

The problem of retaining trained personnel in certain industries, such as the fast-growing electronics industry, is particularly thorny. Job switching in such industries may be relatively easy and may be regarded as the best means of advancement. A company that desires a low turnover in personnel in such an industry may find it impractical to conduct an extensive training program since such a program may ultimately be of as much benefit to competitors as to the company itself. In a highly competitive industry it becomes difficult to pay significantly higher wages and salaries than does the competition. Companies often try to retain people by offering extensive long-term fringe benefit programs, but these are not always successful in accomplishing their purpose. Frequently the people at whom they are directed are more interested in intangible benefits. On the other hand, a company can afford to spend money on such things if, in fact, it can significantly reduce turnover, since the cost of recruiting and hiring is substantial.

Some objectives should be set regarding overtime. Where prac-

tical, these should reflect the preferences of the work force. For example, in a relatively non-seasonal, non-cyclical business which is growing only very gradually and which is in an industry that normally operates on a one-shift basis, a company operating on a 40-hour week could employ more people and operate on a 35-hour week, or could employ fewer people and operate on a 48-, 54-, or 60-hour week. The latter course might be indicated if there were a demand for higher take-home pay and the company could afford the overtime premium (which might not really cost anything because of greater utilization of facilities and overhead), or a long week might turn out to be exceedingly difficult because of the demand for leisure time.

Community Relations: Community relations objectives indicate the extent to which the company desires to participate in community affairs, make a contribution to the community, and avoid actions which would be detrimental to the community. Most companies today accept some community responsibility, although attitudes vary widely. Some firms will accept only a minimum responsibility, which has been forced on them by public opinion or legislation, while other firms assume the leadership in community affairs. A company may act alone, or it may serve as the focal point for a program involving other companies and organizations.

Among the subjects which may be dealt with under community relations objectives are contributions to charities, scholarship programs, use of company facilities for public meetings and public recreation, sponsorship of clubs and organizations such as Junior Achievement and Little League, encouragement of employees to take an active part in civic and political organizations either as representatives of the company or as individuals, and sponsorship of concerts and other programs of cultural value. In addition, community relations objectives can establish policies regarding advertising standards, mobilization of public opinion, and lobbying—both direct and through trade associations. Also to be considered are voluntary control of objectionable activities such as the creation of eyesores and noise, smog generation, and water pollution. Employment stability policies should be stated under community relations objectives insofar as they relate to the general economy of the community, and under personnel objectives as they relate directly to the company's own employees.

Corporate Image: Some firms are almost anonymous, while others are widely known to the general public. Since almost any company, especially a large one, can be looked upon from many points of view and has the potential to create many different impressions of itself, it is desirable to decide which image should be selected. It is often possible and even desirable for a company to create a somewhat different image among the many groups with which it has contact—stockholders, employees, the general public, customers for different groups of products and in different segments of the market. Quite often, corporate image objectives are closely related to other objectives and are partly derivative, since the public impression of the company may have an important bearing on its ability to sell its products and attract qualified personnel.

Frequently the central theme of a corporate image is embodied in an advertising slogan—"Progress is our most important product;" and, "Better things for better living through chemistry."

In recent years, the emphasis on growth and technological progress has led many companies to try to create the glamour impression that they are research-oriented or are engaged in important programs in advanced fields of technology. Quite often, a large company has placed heavy emphasis on a small acquisition in an advanced field with the hope that its new glamour will cast a spell over the full range of the company's products and activities.

Some firms place great emphasis on maintaining a lasting identity by perpetuating the name of the founder or continuing to trade on another past reputation. Others have made major changes in their corporate image over the years. A number of companies start out at the low end of the price spectrum, to create the impression that they are providing customers with major bargains, but they gradually upgrade their line and shift their emphasis to quality as they grow.

Some companies have initially established a reputation in a relatively narrow field and have subsequently greatly broadened their activities without giving proper attention to a corporate image that reflects their new breadth. Careful consideration should be given to the total image which the company wishes to create among specific groups of individuals and segments of its market.

A firm can often be hurt by going into a new field which detracts from its existing line in terms of the impression it creates. For example, a company that produces high-quality products and operates in an industry noted for high standards might enter a field involving intense competition and a general low level of product quality and marginal business practices. Although the company's original intention was to trade on its high-quality reputation, the situation could boomerang.

Chapter II

Evaluation of Resources

An important area of analysis and preparation for merger and acquisition is the evaluation of resources, i.e., strengths and weaknesses. While objectives answer the question of what do we want to do, evaluation of resources answers the question of what do we have to work with, and long-range planning answers the question of how do we expect to do it. All three should be carried on continually since there is considerable feedback among them, thus enabling the continued refinement and modification of objectives and plans.

Management

The capabilities of all levels of management should be assessed and consideration should be given to training, experience, past performance, and apparent potential for further development.

In assessing management people, it is important to probe their underlying motivations. Individual interests, which can be a valuable asset, are too often overlooked. Frequently a company will be more successful in an area where management interest is high, even though company capabilities are only average, than in an area where management interest is low, although company qualifications may be high.

A strong sales management, field organization and distribution

system may be a prime resource of the company while product innovation and development may be lacking. This management condition causes some companies to consider acquisition as a method of attaining new products, creativity, and the means of spreading distribution costs.

Restless, dynamic, entrepreneurial top management is a resource which probably must exist in some degree to capitalize on internal growth plans or to lead the company into a successful expansion through combination with other companies. A forward plan frequently falls short because the leader does not really have the capabilities to direct a proper plan and to cause action. A move to replace the management head may be the first necessary step to launch a successful growth campaign.

Management versatility and depth are especially critical in a major new program such as merger/acquisition. Some companies, in fact, have undertaken merger/acquisition programs as a means of utilizing surplus management resources, while others have deliberately built up a larger and more capable management team than is necessary to carry on the existing business in anticipation of a merger/acquisition program.

Research, Engineering, and Product Development

Technical skills and facilities should be examined in terms of their ability to meet the needs of the existing business and their potential as a base for expansion of the company's activities. The nature of the engineering and development effort should be ascertained, and its orientation—to basic research, applied research, and/or applications engineering—should be made clear. An organization lacking in creativity or, more importantly, lacking the capability of conceiving ideas with commercial value may, on close examination, see its future as bleak. Time runs out for many concerns which have had good ideas or the organization to produce the ideas but which have lost the talent. Acquisition of the skills may be the best solution.

In evaluating engineering and product development, the company should have in mind the trend in technical disciplines involved in the product areas in which it is engaged, i.e., are needs for electrical engineering skills developing in a field which has

been primarily based on mechanical engineering? Is there a shift to organic versus inorganic chemistry, etc.?

It should be determined whether or not the company has on hand, or readily available, adequate laboratory and testing facilities and equipment which enable it to carry out its engineering and development programs efficiently.

Some lines of business require little or no in-house engineering and product development. Should company objectives indicate a change in the nature of the firm's activities, consideration should be given to possible sources of outside assistance. In this regard, the technical aid which suppliers often provide without charge is frequently overlooked but can be an important resource of the company.

Patents

The most important resource of some companies is an adequately protected copyright, patent or trade secret. A careful review of patents should be made with particular attention to such factors as:

1. The date patents were issued and the number of years before they expire.
2. Their susceptibility to infringement, obsolescence, or circumvention.
3. Their applicability to the company's present activities and objectives.
4. Present and projected cross-licensing arrangements—the availability of company patents to others and the availability of others' patents to the company.
5. The significance of patents in the company's line of business, i.e., in some fields patents are extremely important, while in others, they are of very little value.

Product Line and Product Features

In assessing the product line and product features, it is particularly important to make a comparison with the competition, in terms of individual items and the breadth of the product lines. Features not available in competitive products should be identified

as should those features of competitive products not found in the company's items.

Some attempt should be made to assess, from past records, product life and to evaluate the remaining life in existing products and the extent to which they are becoming obsolete. This should be related to engineering and product development resources and to the programs currently under way. Some consideration should be given to the question of whether products are over-designed or under-designed and whether they are sufficiently durable to satisfy the needs of the market.

Product profitability and trends in product profitability should be assessed. The products should be looked at from the standpoint of their susceptibility to minor redesign and modification which might lower their cost of production, enhance their usefulness, or extend their sales life. Automobile engines serve to illustrate this point. A basic engine design for a passenger car often lives through 10-15 years of continuing modification before being replaced by an entirely new design. Plymouth used an L-head six cylinder engine of the same basic design from the early 30's through 1960, when a new slant-six design was introduced. The L-head six was clearly a much more valuable product resource in the late 30's than it was in the late 50's when it had become virtually obsolete.

Packaging and trade marks are important resources for some kinds of products. In fact, packaging is a part of the over-all design of many products.

Weaknesses in the product line often take the form of too narrow a line, lack of optional features, quality inconsistent with the company's objectives, over-design and obsolescence, and/or poor design from the standpoint of manufacturing economy. All these affect the company's competitive position. Such situations often require an extensive rebuilding effort before new programs such as merger and acquisition can be considered: measures must first be taken to strengthen the company's primary resources. In some cases, if deficiencies are restricted to one of the company's product areas, it may be desirable to sell off the deficient product line. However, since the deficient product line still constitutes a resource in terms of the funds which can be obtained through its sale, it should be so evaluated.

Manufacturing

How adequate is the facility, equipment, know-how and organization to reach the corporate goals. If expansion, replacement, modernization leading either to increased capacity, cost reduction, or a change in techniques is needed, this may be gained through a merger/acquisition. A problem is to weigh the costs and time required to "go it alone."

People and their skills are integral parts of manufacturing resources; in fact, they are usually of greater importance than the physical facilities.

Vendors, subcontractors, and materials suppliers should be considered as manufacturing resources and as opportunities for acquisition. In a consideration of future expansion, some judgment should be made as to whether suppliers are capable of meeting increased volume requirements and price demands. Such considerations also have a bearing on the make-or-buy decision and the possibility and profit opportunity of integrating manufacturing activities backward or forward. Conversely, a company is sometimes restricted by being dependent upon a single, outside source for certain items, particularly if it is difficult to develop other sources and the supplier is either unwilling or unable to increase his sales to the company. A review of suppliers as a resource may indicate both problems and opportunities.

A company which controls the source of raw materials it uses and has ample supplies of such materials which can be obtained very profitably will seek opportunities for ways of using more of these materials.

Marketing

(i) Organization: The marketing organization, a company's bridge to its customers, is frequently its most important resource. Evaluation of the marketing organization should include both physical distribution and personnel.

A primary consideration is the depth and breadth of coverage provided by the marketing organization, i.e., its ability to reach important customers and potential customers. Companies often

divide the country into a number of sales territories, but actually cover only the metropolitan areas and miss substantial potentials in rural areas, or they do not, for cost or other reasons, cover entire geographical areas such as the West Coast for an Eastern manufacturer.

An evaluation of the physical distribution system should give attention to such matters as quotation and order handling procedures, location of field inventory, transportation, order-delivery cycles, stock-out problems, and availability of repair parts.

The marketing organizations and distribution practices of competitors should be examined and compared with those of the company. Although a marketing organization need not be very similar to a competitor's, analysis of differences can often help to focus attention on particular strengths or deficiencies.

Marketing organizations are susceptible to obsolescence, just as are product lines and manufacturing facilities. Distribution patterns in specific markets often go through significant changes. Such trends should be identified in evaluating the marketing organization and an attempt made to ascertain whether the existing organization is moving with the trend or is capable of moving with it.

The skill levels and technical backgrounds of the sales force need review in the light of possible increasing technical complexity of the product line and its applications. Many firms which serve a number of markets have found it necessary to develop industry-oriented applications specialists within their marketing organization in order to provide adequate service to customers and to identify additional product applications in given industries. In technical fields, it is especially important to evaluate the adequacy of the sales engineering effort in terms of the extent of coordination between the sales force and the engineering department and the company's ability speedily to provide customers with needed information.

Consideration should be given to the degree of control which the company has over its field sales force—does the firm utilize direct salesmen or independent manufacturers' representatives or distributors? Companies in the latter category should be concerned with the stability of the organization representing them. Serious

management succession problems in present representative organizations (or lack of alternative representatives in key areas) can be a major weakness.

Some thought should be given to advertising and promotion methods and to their effectiveness.

The ability of the marketing organization to gather market intelligence can be an important resource. Information gathered by the sales force through contacts with customers and other trade sources can be very helpful, both in planning for present product lines and in considering new areas to enter.

In evaluating the marketing organization in terms of its ability to handle new products, it is quite easy to overlook the possibility of overloading: the organization might have the skills needed to handle a new product line, but the marketing organization may already be fully and productively occupied with its present business and may lack excess capacity.

(ii) Markets and Market Position: In an evaluation of the markets served, trends in customers' businesses and their future requirements should be analyzed. Information should be developed about the competitors' marketing and distribution organizations, their reputations, their practices, and trends in their market position. Their technical capabilities and production capacities, as well as their financial strengths, should be assessed. The company's reputation in relation to its competitors' also needs careful examination. Outside consultants can be very helpful in assessing a company's reputation, since they can make an anonymous approach, can get unbiased comments from customers, and are often able to obtain information on the competition, by a direct approach, which otherwise would be unavailable.

An established position in a market can be a significant resource of a company, particularly when it depends heavily on personal relationships and involves a mature market. A strong position can serve as a base for increasing the number of products and services offered to the market. It is exceedingly difficult to break into a mature market with which a company has had no previous contact, and it is far more difficult to increase market share in a mature market than in one which is going through a period of substantial growth. While this can be accomplished, it usually de-

pends on factors beyond the control of the company such as a significant decline in the capability of an important competitor.

In a growing market, the state of market development has an important bearing on its value to the company. A relatively small market in the early stages of development may be of considerable significance, but forecasting future growth in such situations is very difficult. More than one company has entered a developing market, expecting major growth, only to find that the market is highly specialized and has insufficient potential to be of long-term interest. Other companies have found their leading position in a developing market to be relatively valueless because the market is easy to enter and is vulnerable to intense competition as its growth accelerates.

The value of a position in an already sizeable market that is going through a period of substantial growth depends on the ease with which competition can build up production from scratch and/or the likelihood of pioneer firms, which have only limited capabilities for keeping pace with market growth, being acquired by large companies with extensive resources. If the subject company itself has only limited capabilities, the value of its market position depends on its objectives. If the company is not able to continue to participate in the market and grow with it, its market position may be of little value. However, if the company has an excellent opportunity to dominate a specialized area of the market or sell out to a larger firm, its market position may have considerable value.

The possibility of new competitors entering the field should not be overlooked, and an attempt should be made to identify potential competitors. Possible integration moves by customers, which would eliminate or reduce the market for the company's products, and/or possible marketing of surplus production by captive facilities should also be reviewed.

Financial

Whether a company plans to grow, diversify, or improve profit performance by internal development or by acquisition, a program of any proportion runs into the problem of finance. The magnitude of the problem will undoubtedly be substantial for the

average merger or acquisition. A review of inside resources and the company policy toward the use of those or outside resources is a necessary preliminary step in a total program.

(i) Existing Resources

Cash level is frequently set to provide a floor relating to some norm, i.e., a per cent of sales. Excess cash above the minimum floor may be considered available.

Receivables level may have been allowed to run higher than would be possible if demands for acquisition cash were made. It may be possible to press the credit and sales departments into a program of reducing the average collection period. Or, the corporate policy on factoring receivables may warrant adjustment for a short-term to extract useful cash.

Inventories, as in the case of receivables, may be set with a floor which can be lowered if a corporate growth or acquisition plan were to need internal financing.

Fixed Assets policy may have demanded outright ownership in the past but for a program requiring substantial resources the use of sale and lease-back may provide a cash base. This study will not cover the intricacies of this method of financing but suffice it to say there are many advantages and disadvantages to its use and there is one large advantage, that of providing a source of cash for an aggressive program.

The corporate policy on turnover of assets may well be reviewed to assure that unused real estate, idle machinery, etc., which have been considered "good investments" are worth keeping in a relatively unproductive state as opposed to the possible contribution they can make to available cash.

Depreciation in many companies is a large cash flow item to consider as a source of funds. A careful review of the intended application of funds may show that depreciation cash has been spent with general regularity for replacement or betterment of existing facilities but may be more wisely directed toward new facilities or acquisition opportunities. The use of accelerated depreciation may be considered to provide earlier tax savings and cash.

Dividends, if paid in the past, may be reconsidered as to corporate policy. Perhaps the future gain from the retention of earnings and their use in an R & D or acquisition program will be such as to repay the passed or reduced dividends many times over. The issuance of stock dividends, in lieu of cash, may be selected as a source of cash.

(ii) New Resources

In general the new resources are categorized as increases or changes in the liabilities side of the balance sheet. Corporate policy and restrictions imposed by the existing current liability sources and the agreements and covenants made with long-term capital must be reviewed and, perhaps, modified.

Short-term loans are, in the main, not particularly useful in the average program of growth or development as their payback is too soon. The corporate policy on current ratio may be reviewed, however, and to the extent the ratio can be reduced without jeopardizing the business, it may be possible to secure capital on revolving bank credits or from materials suppliers. If the corporate policy has been to discount all invoices, the gain in cash discount may not be worth the policy and the funds available may be made more productive in a sound acquisition; however, the more likely source at lower cost will be in the long-term capital.

A strict policy of little, or no, use of debt leverage has been a restriction on growth for some companies, and for other aggressive concerns the use of debt has been the support for substantial growth. Where problems of equity dilution exist, the corporate policy on leverage will bear review since secured debt or debentures can either provide cash or be the medium for the purchase of an acquisition (as a medium of exchange, debt is brought up in a later section on negotiation). With regard to debt, it is appropriate to caution as to covenants of debt agreements in either existing debt contracts or in new ones. Regardless of covenants, many companies review their general acquisition or merger plans with principal suppliers of capital but, of course, with greater purpose if certain restrictive clauses must be adjusted. Typical agreements carry clauses restricting working capital to a specified minimum or to a percentage of outstanding Funded Debt. Other covenants bear on

the disposition which may be made of surplus in dividend payments, repurchase or redemption of stock, or other distributions where the effect is to reduce assets which the lender considers as support of the loan, or which distributes an amount greater than the net earnings generated.

As to covenants relating to consolidation, merger, or sale, a clause from a typical agreement reads:

> "The Company will not consolidate or merge with or into any other corporation or sell, convey, lease, transfer or otherwise dispose of all or any substantial unit of its property, but any other corporation may be merged into the Company, which shall be the surviving corporation, if the Company is not, immediately after such merger, in default under any of the terms, covenants and conditions of this Agreement and the Notes."

Stock if intended to be used for acquisition or merger poses many problems to be resolved, both as to corporate policy and as to the details of issuance. Some of the details in the use of stock are covered in later sections under the headings of Legal, Tax and Accounting Considerations or under Negotiation, Evaluation, and Approach and Exploration. In considering the resources available, there are several problems. An example is: dilution of stockholder equity must be considered in the issuance of further common stock. The dilution policy may have to be faced in order to permit a substantial investment in another company. If voting control has been closely held and existing shareholders are reluctant to dilute their control there is a major obstacle to the use of common. A possible solution lies in the use of non-voting common or preferred, but this eliminates the tax-free merger route.

The usual policy for an aggressive corporation relates to the consideration of dilution of earnings in the near term, after an acquisition, in order to enhance earning at a later date or to dilution of net worth per share to produce an opportunity for an earnings increase per share. The directors and shareholders will probably treat problems such as these in only a general sense until such time as a possible acquisition merger candidate is being evaluated. Part of the bridge can be crossed by authorizing sufficient shares to meet an intended program and to have the required

shareholder approval, stock exchange approval of listing, and filing with SEC and other agencies, where appropriate.

If the directors believe the market value of their common stock to be undervalued in terms of asset value, it may be wise to consider purchase of stock to hold as treasury stock for acquisition or merger use. The use of treasury stock can save the underwriting costs of a new issue but perhaps of greater importance to remaining stockholders is that equity dilution may be minimized by a program of acquiring stock for use as treasury stock in a later stock-for-assets or stock-for-stock transaction. This procedure, in effect, uses cash for acquisition but with an exchange which results in a more favorable equity position for the stockholder. Such a repurchase program may take considerable time to effect and will probably have to fit into a well-planned total strategy. Again, the restrictions in loan agreements must be considered.

The limited resources available may be made more useful in a deferred payment plan of acquisition, examples of which are discussed in the Negotiation section. The advantages are obvious provided the conditions for implementing a program can be met. If cash is short or the price negotiated becomes high, it may be advisable to go to an installment plan, perhaps based on earnings, in order to finance the opportunity.

(iii) Post Merger Resources

Not all the financial problems relate to the first cost of acquisition; there are those which occur when the consolidation has been made and the opportunities or necessities arise to finance programs brought about by the fusion.

The acquired company may not turn out to be as attractive as first analyzed, and this is not unusual. Some additional funds may be needed to cover weaknesses about which the seller may have had knowledge but which he did not disclose, or he may not have been aware of the future difficulties. Competition may have been getting severer so that a stepped-up promotion program may be necessary to protect the estimated earnings. Some extra cash should be left to carry out both anticipated programs and the unanticipated since many mergers/acquisitions just do not produce the "1 plus 1 equals more than 2" synergism.

Chapter III

Forward Planning

As a result of having defined company objectives and having evaluated corporate resources, the development of a plan of action for merger or acquisition should be more readily accomplished. The background preparation will be useful and in fact essential in a rational approach to a negotiation process. The planning period should cover the time during which the major impact of such commitments will be felt and during which the pay-out on these commitments will take place.

Obviously, the ability to predict events accurately decreases as the time period increases, and there is a time beyond which it is impractical to develop detailed plans. This accuracy varies considerably from industry to industry and is a function of many factors including product development cycles, resources development time, the rapidity with which physical facilities can be established, and the time necessary for significant development. Most authorities agree that some form of planning should be undertaken for a period of at least five years. In some industries, it can be extended to ten years or more. Plans for the first year should be detailed, but they may be very general for the fifth year.

A large part of the planning process involves identification of alternative courses of action and analysis of their relative attractiveness. A company usually has several choices open to it at any given time.

Most companies must make changes in their business over a period of time if they are to survive. These changes may be quite gradual or relatively rapid. It is exceedingly difficult, if not impossible, for a firm to effect a change which has no relationship or continuity with the present business.

Growth Directions

Principal new programs or alternative courses of action might involve one or more of the following:

1. Geographical market expansion. A company selling only in a regional market begins to distribute its products throughout the nation.

2. Geographical expansion of production. Branch plants are opened in order to better serve the needs of particular geographical areas, or production is decentralized to take advantage of favorable conditions in other areas—lower labor rates, favorable tax structure, or proximity to markets.

3. Broadening of product line. Similar items are added in order to meet better the needs of existing customers or to develop additional customers with related needs.

4. Vertical integration. Parts, materials, or assemblies are no longer purchased but, instead, are processed or manufactured; or, functions of further assembly of a company's products, marketing or distribution of the products are absorbed. One direction leads to the primary source of raw material and the other to the ultimate consumer, but all movement is related to the present product line.

5. Radical improvement or redesign of existing products (as distinguished from minor product improvement). New products are designed for sale to the customers of existing products, but they are intended to replace or make the current products obsolete.

6. Disposal of unprofitable activities. A product line, a manufacturing plant, or a distribution facility is sold.

7. Liquidation (of a division or the entire operation). The

owners of a closely held company liquidate in order to obtain funds to enter a new unrelated field of activity.

8. Entering new fields (diversification). Diversification can be defined in many ways. If it involves entering a field which bears no relationship to the company's existing business, it is purely a financial move. This type of diversification is the most difficult to carry out successfully, not only because of lack of applicable experience but also because of lack of a sound basis for choosing a field. The second type of diversification involves entering markets in which the company has previously not been active, perhaps, with new products to obtain products which can be manufactured in the existing production facilities and with existing manufacturing technology. A third form of diversification involves a change in manufacturing, i.e., the introduction of new products requiring a new manufacturing plant and entirely different production processes but which are sold to the same customers through the same marketing organization.

Alternative Methods of Implementation

These alternative courses of action may be implemented in a number of different ways. One means of implementing is merger/acquisition; however, it is by no means the only one. A company might implement a program by reorganizing and re-applying its existing financial and operating resources or by conducting research and engineering directed toward developing new products or manufacturing processes. A company might obtain additional finances, attract additional people, or construct new facilities. It might obtain licenses to products or patent rights, or set up cross-licensing agreements. It might purchase product lines from other companies, either with or without facilities for their manufacture. In essence, a company may often take steps short of merger/acquisition which will accomplish its objectives and implement its plans.

Reasons for Merger or Acquisition Route

Companies consider merger/acquisition for a variety of possible reasons, as mentioned below, but the most common underlying reason in the majority of cases is probably that of gaining time. This is particularly true if it can be assumed that the management

has the ability to reach its goals through internal development. Some managements would never add the right personnel or motivations to accomplish the aims without bringing in products, facilities, a team, or cultivated markets. They surely would be buying time.

In addition to satisfying one or more of the broad alternative courses of action mentioned above, why is merger/acquisition selected by the buying or aggressor organization?

A. Financial Reasons

1. Exploit an opportunity
2. Avoid the risk of internal development programs
3. Use idle capital
4. Take advantage of a tax loss, i.e., secure one or apply an existing one
5. Increase market value of stock
6. Effect more rapid growth
7. Improve on profit level or trend in present business
8. Secure a source of capital
9. Spread the business risk
10. Provide a market for stock

B. Operating Reasons

1. Improve on volume level or trend in the present business
2. Offset seasonal or cyclical fluctuations in the company's present line
3. Satisfy customers' demands for additional services or items
4. Reduce dependence on a single product
5. Broaden the customer base
6. Obtain business in a new territory
7. Acquire new customers and new markets
8. Take advantage of an existing reputation
9. Obscure the details of the primary area of activity from competitors through diversification and the publication of the consolidated statement
10. Obtain a research and development group
11. Strengthen the management
12. Acquire particular products
13. Increase utilization of present resources—any or all types

of resources which the company has at its disposal, including physical facilities, individual skills, surplus funds. Find opportunities to use raw materials whose source of supply it owns

14. Enhance power and prestige of the owner, president, or management of the company
15. Provide an outlet for frustrated interests or excess management capacity
16. Add glamour and greater interest to the company

It is particularly important that a firm recognize the basic reasons why it decides to consider merger/acquisition, especially when it begins to consider prospects. It is very easy for a firm to rationalize its decision for merger/acquisition, even though the choice may offer advantages which were not sought initially.

Merger and acquisition often enable a company to reach its objectives much more rapidly than do other means. Sometimes, however, acquisition demands a lengthy assimilation period and incurs problems of far greater magnitude than would a different method of reaching the same objectives.

The merger/acquisition route may entail less risk than an internal program since the company being acquired has already produced known results. The problem rests in properly assessing what the company has accomplished and in assuring that there will be a continuation of the conditions under which these results have been produced.

An acquisition can enable the company to reach its objectives economically. The acquired company may have developed a product line or manufacturing facility in the past at far lower costs than presently prevail, or more recently by a costly trial-and-error procedure. The prospective acquisition may have a strong market position in the field the acquiring company wants to enter; fighting a competitive battle with the company to be acquired might be a costly means of market entry. On the other hand, acquisition may be by far the more costly route, especially if the company to be acquired is in a growth field where stock values are highly inflated. For example, at today's price-earnings ratios, the acquisition of a small-to-medium-sized electronics company might be foolhardy

compared with attracting a qualified staff and building an internal electronics operation.

Through acquisition, a company may be able to obtain resources (either facilities or people with unique skills and knowledge) which could not be duplicated. With respect to the latter, great care must be taken to obtain assurance that the individuals will remain with the acquired company after the merger is consummated. Often a company which is acquired has some resources or characteristics which are unwanted, undesirable, or bear no relationship to the acquiring company's interests. In such cases, the acquiring company is faced with the problem of disposing of these unwanted resources or finding some rationale for utilizing them. A company might, for example, make an acquisition in order to obtain a product line which could be manufactured in its own available facilities, these facilities being more efficient than those of the acquired company.

Merger/acquisition can significantly increase the motivation of the key personnel of either company, or both, by making an individual part of a larger organization with greater opportunity or by providing an opportunity to apply unused skills and knowledge. There is considerable danger, however, that the motivation of the key personnel of the acquired company can be seriously reduced by an acquisition, particularly if the key personnel have had a sizeable stake in its ownership. After acquisition, they may feel that they are no longer managing their own business and that it has lost its identity to a large organization. If they have been accustomed to setting policy, they may find it difficult to follow policies laid down by others.

Under certain circumstances, a merger/acquisition may help to stabilize a market by absorbing competition. The antitrust laws are relatively lenient regarding the acquisition of companies facing bankruptcy. Such firms may have upset the market by price cutting and may still be able to cause difficulty for the acquiring company. Great care must be exercised in fully understanding the antitrust provisions should acquisition of a competitor be undertaken.

Disadvantages of merger/acquisition include the possibility of serious personal frictions, and purchase of a bad reputation, and the introduction of an undesirable union. Although these prob-

lems may be outweighed by advantages, the acquiring company should be on the lookout for disadvantages of this sort.

Merger/acquisition, then, is a part of long-range planning and is one means of implementing company plans and reaching company objectives. The long-range plan which defines how a company will utilize its resources to achieve its objectives should specify the contribution of merger/acquisition to the over-all plan. If long-range planning is carried out correctly, it puts merger/acquisition programs into proper perspective with the over-all objectives of the company. Establishing company objectives, evaluating resources, and making a long-range plan are fundamental to the consideration of merger and acquisition—by both the acquiring company and the acquired. The steps discussed above form a solid foundation for both companies' evaluation of advantages and disadvantages and their solution of the attendant problems.

Chapter IV

Criteria

Once a company has decided to undertake a merger/acquisition program, it is ready to devote its attention to the specifics of the program:

1. The definition of the fields in which to search for a suitable merger or acquisition prospect.
2. A basis for accepting or rejecting specific prospects.

Criteria for acquisition policy within these two major classes should be assigned priority; for example, those which must be met, those which should be met, and those which are not critical. These two latter groups serve as guidelines in decreasing importance. If all criteria were to be met, very few programs would get off the ground.

Not all of the criteria established are necessarily to be submitted to outside sources of lead information. For example, although commercial banks or investment houses may be willing to provide leads without a substantial charge for service, they are in effect limited in the time they can devote to analyzing desires and identifying likely candidates. A short statement selecting the primary criteria is about all that will be absorbed. A description of the general industry classification and perhaps sales volume may be most productive, whereas an elaborately prepared multi-page document may be heaved into the pile "to be looked at later".

Preparation of criteria involves translating the statement of

company goals, the statement of corporate resources, and pertinent portions of the long-range plan into a suitable form. Obviously, not all facets of these entities will be incorporated into the statement of criteria for merger/acquisition, but they establish the foundation.

Most of the difficulties encountered in attempting to set a direction for merger and acquisition result from failure to establish objectives, evaluate resources, and formulate long-range plans adequately.

Industry

Definition of the fields in which to search provides a basis for building a list of companies for preliminary consideration. This may restrict the search to one or a group of industries, to companies making specific products, and to companies located in or selling to a particular geographical location, and/or to companies within a particular size range. They also may indicate the nature of the operation: is activity primarily in manufacturing or marketing; is it research-oriented, development-oriented or production-oriented; and is it diversified or concentrated in a single product line?

Sometimes definition of the area in which to search is relatively simple and is quite specific; for example, a company seeking to enter a specific industry or product area might find its choice of size limited, by its restricted available cash, to a dozen of the smaller companies in the industry.

In some instances, the industry criteria are very broad and the initial criteria need further refinement or restatement in terms of definitions used in the presentation of trade directory listings and/or government statistics. For example, one company interested in a purchase purely as a means of employing surplus capital established guidelines specifying consideration of companies, in technologically based industries, whose success was primarily dependent on engineering and research and development. This criteria was further refined to a list of some 85 four-digit SIC industries which were selected as being technologically based from among all 435 four-digit SIC manufacturing industries.

Product line criteria pose the same kind of problems as industry criteria.

Criteria concerning location are relatively easy to define and can provide a basis for reviewing state and metropolitan area trade directories. Such criteria, however, can easily be over-emphasized: in many instances the general geographical location of a proposed acquisition is actually of very little importance, and a company may restrict itself unduly by specifying a particular location. Sometimes the location criteria may be selective within a general area; for example, it may be desirable to have the potential acquisition located in a community larger or smaller than a certain size or in a municipality which has certain public utilities available or which has a highly favorable tax structure. Sometimes location criteria can be helpful in making the search; at other times they should be used for review after initial identification of prospects.

Criteria specifying the size of the company to be considered may be relatively easy to state in terms of what the acquiring company is trying to accomplish but may be somewhat difficult to relate to published data, particularly if size is stated in terms of the investment to be made or the maximum amount of money that could be paid for an acquisition. The approximate sales volume and the number of employees of a great many companies is readily available in trade directories. For many companies, net worth figures as well as the calculated market value of the outstanding stock can be readily obtained from secondary sources. Some such information cannot immediately and readily be translated into a purchase price or acquisition value range, while other such information, if taken at face-value, may give an unrealistic impression.

It is usually desirable to develop some rules of thumb applicable to the industries which will be of interest for use in aiding the search.

Although these may not be highly accurate, they can be used to eliminate companies which are clearly outside the size range under consideration. The company size criteria is most useful as a searching tool when the size range of interest is substantial, particularly when a fairly broad range of industry is under consideration. It is usually much more difficult to identify very small com-

panies: they are often not listed in standard reference sources either because they are quite new, because they have been overlooked for some other reason, or because the trade directories only list companies above a certain size.

Criteria describing the nature of the operation are usually not useful as a primary basis for a search, except in special cases, but they can be helpful for secondary screening. Exceptions are kinds of operations which may be covered in special directories, i.e., research laboratories, certain classes of wholesale trade, organizations likely to employ members of professional associations whose directories would list the companies to be investigated.

Company

The second major class of criteria, which provides a basis for accepting or rejecting specific prospects, is that which measures the compatibility of the proposed acquisition with the acquiring company's activities and the extent to which the proposed acquisition provides a vehicle for reaching corporate objectives. Some of these criteria may be used for preliminary screening, while others will be utilized during detailed investigation and analysis of specific companies. Such detail may specify requirements of profitability, growth prospects, the nature and extent of the prospective acquisition's resources, its reputation, personality factors, labor relations situations, the specific nature and quality of products, and the price which would be acceptable in relation to the value of the company being acquired, i.e., price/earnings ratio or the value placed on certain resources by the acquiring company. Care should be taken to give the proper weight to specific requirements and to avoid setting down standards which are superfluous and/or bear little or no relationship to the company's fundamental requirement.

Acceptance or rejection criteria should be parallel to, but not necessarily be identical with, the company's objectives. For example, a company may have an over-all profitability objective which is different from the profitability criteria for merger/acquisition. The latter might be higher if the company anticipates a decline in profits in its regular line of business and has entered into a merger/acquisition program primarily as a means of maintaining over-all corporate profitability. If, on the other hand, the company's exist-

ing line of business is very profitable and it has built up a substantial surplus which cannot be effectively invested in the existing business, it may be satisfied with an incremental profitability which is lower than the over-all average. Timing can also play a part; the company may be willing to forego profits in the initial years following acquisition if it can be demonstrated that significant profits are likely to be generated in later years.

Although historical performance is significant in evaluating a proposed acquisition, the acquiring company should be primarily concerned with the future outlook. Criteria do not constitute a simple formula which can mechanically evaluate the historical facts of the potential acquisition and produce an automatic acceptance or rejection; careful analysis and forecasting are required in addition. The acquiring company should keep in mind the extent to which it may benefit from a change in the character of the acquired firm, and the likelihood of the combination of the two companies having a synergistic effect. In extensive programs involving the review of many companies, it is not always economically feasible to analyze each prospect in detail; however, even in such cases the application of criteria should not be allowed to deteriorate into a mechanical procedure.

The validity of the criteria should be checked from time to time. Companies which have been identified should be reviewed, and acceptance or rejection recommendations resulting from preliminary examination by top management should be examined closely. If the criteria are accurate, management should concur with the progress of the program. However, management disagreement will sometimes indicate a necessity for making modifications to the criteria. Modifications should be made only after careful examination of the reasons for disagreement, since it may result from a lack of understanding of the facts or from additional facts which were not taken into consideration.

A specific prospect will have its own unique advantages and disadvantages and probably will not meet all of the criteria, especially if they are too severe. If the company is unrealistically stringent in its requirements, its merger/acquisition program may turn out to be nothing but a fruitless search. It is equally dangerous to set standards too low or to modify criteria significantly in the latter

stages of a program for the sole purpose of consummating an acquisition without reference to the initial purpose of the program.

A common error is to conduct a search for the "ideal" acquisition. There may be a one "best answer," and there are probably some acquisition prospects which will prove to be better than others. Nevertheless, the criteria should be thought of as a set of minimum standards for providing a satisfactory solution to the company's problem.

It is desirable to be able to choose between several alternatives, but this is not always practical in merger/acquisition activities. There are limitations to the number of companies which can be examined in depth at one time, because of the limited number of personnel to conduct the investigation and the degree to which prospective acquisitions will allow preliminary negotiations to extend over a lengthy period. The detailed evaluation and examination of the company usually requires the expression of a serious interest by the acquiring company and the co-operation of the company to be acquired. In many instances, procrastination may terminate negotiations and lose the opportunity, particularly if there is competition involved. The acquiring company must often consider the prospective acquisition as a "go/no-go" situation. It must decide whether a possibility is acceptable or whether it will gamble on a better one being identified later. Companies which delay with the hope that an ideal acquisition prospect will materialize may suddenly discover that all the good prospects have been purchased and that they are reduced to choosing from the less desirable prospects.

The acquiring company should be fully cognizant of the unique advantages of a combination. The fact that a company has been rejected by other firms engaged in acquisition programs does not necessarily mean that the company is undesirable; a poor risk for one company may be a good one for another. It is quite unlikely that any two companies engaged in an acquisition program are utilizing identical criteria.

Chapter V

Organizing for Merger or Acquisition

No matter who is responsible for the direction of the day-to-day acquisition problems, the unqualified approval and support of the chief executive officer is essential. In many instances the president may handle the detail as well as policy determination but the main point is that the keystone of an effort as major in corporate activity as a merger or acquisition is the "top man". He must be well informed as to objectives and the means intended to reach them. Too many programs carried on by aggressive divisional managers, for example, have died for lack of collaboration and co-operation at the top.

The planning program need not be the work of the action-oriented individual but the probability of success is greater if the planning and action can be the common effort of the same man or at least if he has participated in the development of the plan. The likelihood is that he will need full background understanding in order to find the right opportunity, convince some candidates to consider serious discussion, and to negotiate a satisfactory deal. In some cases the planning is done by one segment, the president, group vice president, or staff executive, etc.; the search is by a consulting group or by a director of acquisitions; and the final negotiation is led by even a third element, the financial officer, head of division or department to which acquiree would attach, with final approval by the chief executive.

As in so many bargaining situations, it may be well to hold the big cards in reserve where they can be used if the negotiations become difficult. Presidents are frequently not constituted to plod through much of the detail and frustration of major efforts. This is particularly true today when a greater amount of analysis and searching is needed to develop a workable deal. There is the appropriate time for the ultimate decision makers to meet. The right time must be left to judgment, depending on the personalities involved. Some presidents are tremendously inspiring leaders whose dynamic personality can be used to pave the way for detailed discussion with a difficult prospect. Other presidents, by their obvious aggressiveness, ride rough-shod into tender ground and foul a potential situation at the first meeting. They may try to impress their policy of meeting problems of personnel, for example, in an understanding manner, but the prospect learns quickly that such is not the nature of the dominant autocrat!

Sometimes, in a divisional operation, the division manager is not brought in until much of the program has moved along. If the manager is to be given ultimate responsibility, he should be a part, or the key planner, of the group.

As amplified in the sections on search, evaluation, and negotiation, technical competence may have to be retained since, for most companies, a merger or acquisition is a "first-time" situation. The tax attorneys, legal counsel, and appraisers and evaluators who have had to work out the complex problems will probably be necessary adjuncts to the team.

In preparing for a merger/acquisition program, an acquiring corporation will probably utilize representatives of all of its major functions. Considerable staff work is needed for planning, assembling and evaluating information, and opinions should be solicited from marketing, finance, accounting, production, procurement, and technical personnel. The relative importance of these various specialties will, of course, depend upon the nature of the company to be acquired and the skills available within the acquiring company.

Chapter VI

The Prospect Presentation

The acquiring company should prepare in advance for initial contacts with merger and acquisition prospects. The initial contact is critical in that the acquiring company must stimulate the other's interest sufficiently for it to engage in further exploration of the possibility.

Each approach should be tailored to the circumstances.

The acquiring company should obtain as much prior information as possible concerning the prospect, and it should compile a full statement of advantages to be gained by association with it. Nevertheless, prior to identifying a specific prospect, the acquiring company can benefit from the preparation of basic material about its program. There is an advantage to the exercise of putting the company in the perspective of a possible associate.

The presentation should be tailored to the specific prospect on the basis of information developed about it and reasons why it might consider being acquired. The merger and acquisition criteria should be used as a guide in preparing the following statements. Third parties aiding in the search should, of course, receive copies of the criteria for their own use. While it is sometimes worthwhile to show the criteria to prospects and to discuss them in initial meetings, it is often undesirable to do so.

History and Present Business

Since the prospect may not be especially familiar with the acquiring company, or may have an inaccurate and distorted view

of it, the acquiring company should be prepared to describe its present business. It may be useful to describe certain aspects of the business in considerable detail while touching only lightly on others. Sometimes it is useful to assemble a set of catalogues describing the company's products. A publicly held corporation may use copies of recent annual reports (some closely held companies may not want to release operating figures until negotiations are under way). A brief history of the company and references to particular accomplishments can be helpful. Brief biographical sketches and achievements of top executives or outstanding key personnel may also be useful. Photographs of plant and equipment may also be helpful.

A brief summary of the chief facets of the company's present business should be prepared, for oral or written delivery. If the acquiring company plans to make use of consultants, business brokers, banks, or other third parties, in order to remain anonymous, it should develop a specially tailored statement which does not reveal the identity of the acquiring company but creates a reasonably accurate impression.

Objectives and Plans

A carefully prepared summary of objectives and plans for the future should also be developed. This should be based on the statement of company objectives and the long-range plan covered in previous sections but should not necessarily include all aspects of these (since certain phases may be regarded as confidential). This statement should be designed to create a favorable impression, but should be as accurate as possible and certainly should not be misleading. If a third party is involved, a special version for its use may be needed.

Reasons for Merger and Acquisition

The acquiring company should be prepared to indicate the reasons why it has decided to take the merger/acquisition route as a means of achieving its objectives and implementing its long-range plans. While this statement should touch on the advantages which the acquiring company hopes to realize, it should carefully avoid creating an impression or making statements which might give the prospective acquisition a bargaining advantage.

Special emphasis should be placed on the advantages which would accrue to any company by virtue of association with the acquiring company.

Preferred Means of Exchange

The acquiring company should be prepared to state the means by which it would consider consummating an acquisition; i.e., cash, common stock, preferred, combination, payout of earnings, etc. This statement might be restricted to one preferred means or it might describe several if the acquiring company is quite flexible and has no particular preference. The advantage of the preferred method to the acquired company should be pointed out. The statement of preferred means would, of course, be particularly useful if the acquiring company is making use of a third party.

Part II

Action

There are undoubtedly many instances of fortuitous mergers in which a company inadvertently learns of the availability of another company for merger and acquisition. In these circumstances the problems of effecting a successful merger/acquisition are greatly simplified. These situations, however, can hardly be relied upon to arise unsolicited when a company decides to undertake a program of one or more mergers and acquisitions. A systematic program of dogged effort is ordinarily needed to carry a merger/acquisition program through from its inception to a successful conclusion. The probability of success in such a program is greatly enhanced by the preparation prior to making contacts outside the company.

Part II discusses various factors which may call for great expenditures in time and effort and may require considerable professional assistance. By considering these problems and how to approach them, an acquiring company can proceed in an orderly way from the establishing of objectives to the consummation of a merger.

Chapter VII

Search

By the time a company has established the criteria for an acquisition program it has become rather specific about the kind of attributes it wishes to buy, whether these are strong management, production facilities, new products, or profits. The problem nevertheless remains of identifying companies that meet these criteria and are willing to carry on a serious exploration of mutual interest. Finding companies that fulfill both of these conditions poses many problems of a type best solved by methodical procedures.

The central problem is the nonavailability of complete information of the type that would be most useful for making a decision. The objective of the search, then, is to find an appropriate company willing to entertain propositions that it sell or merge with the acquiring company. Thus, two types of information are needed: what companies meet the criteria established, and what companies are willing to deal. The first type of information is obscured by the unwillingness of many companies to disclose operating figures in the detail needed, and the second type of information is generally not announced since management recognizes that an announcement that it is "on the block" weakens its bargaining position and undermines the morale of employees.

Given this problem, it is obvious that the acquiring company can proceed in either of two ways. It can begin by searching for an ideal match of characteristics with its criteria and then determine

whether the owners are willing to negotiate. Alternatively, it can search for companies willing to negotiate and then screen the available companies for the degree to which they meet the criteria. The latter method has some merit in that it narrows the search at once to companies known to be available. However, since this approach is likely to produce a list of companies with widely varying characteristics of product, size, and function, it is usually employed by an acquiring company with surplus funds that is seeking investment opportunities which will provide a suitable return irrespective of the nature and role of the acquired company. It is not an efficient means of locating a company whose strength will complement the weaknesses of the acquiring company and whose weaknesses can be lessened by the acquirer's advantages.

The usual procedure for an acquirer who has definite goals not solely related to investment is to build a list which identifies the universe of companies meeting the broad acquisition criteria, to obtain enough information about these companies to narrow the search to the most attractive ones, and to determine the willingness of these attractive companies to negotiate.

For the Ideal Company

In establishing its acquisition criteria the acquiring company has established certain broad characteristics of interest to it. Ordinarily, for example, it knows the industry or industries in which it is interested and the function of the company it wishes to acquire. For example, it may determine that it wants a manufacturer of office equipment. The first step, therefore, is to assemble an all-inclusive list of the universe of companies which fit these broad criteria. This can be done in almost any industry by the use of trade directories, association directories and publications, or such additional sources as Dun and Bradstreet's *Million Dollar Directory,* Thomas' *Register,* and similar reference works. It may be advisable to attend industrial shows, meetings, or conventions of the industry of interest in order to identify promising products, meet representatives of the industry, and let it be known that you are seeking an acquisition in the field.

By whatever means the acquiring company assembles its listing of the universe of companies that meet its broad criteria, it is useful, if the list is long, to narrow it by use of the other high-priority

criteria and thus screen out companies unlikely to be of interest. For example, limits may be set as to minimum or maximum sales volume, existing share of market, profit margins, geographical markets served, existence of brand franchise, listing on a national stock exchange. Rough dimensions or conditions may be set in order to narrow the field quickly to a manageable number of companies on which detailed information may be researched or with which exploratory conversations may be held.

The information sources available to the acquiring company are numerous and varied. A thorough search should be made of published information relating to the companies in the field. These sources may include anything from articles in trade journals, to financial and investment services, to credit reports. Published information alone may be sufficient to enable the acquirer to eliminate a company from further consideration or to determine that it is of great interest.

It is often possible to obtain a large amount of data from informal information clearing houses. Trade associations, for example, can be very useful on the nature and prospects of the industry, can sometimes identify companies that meet the criteria, and are an excellent way of circulating word to the industry that a prospective buyer is interested in discussing mergers and acquisitions.

Banks, too, can be a fruitful source of information. Some banks have established departments for the exchange of information on buyers and sellers. They maintain lists of companies interested in acquiring and interested in selling and try to match the two where possible. They regard this service as conducive to good customer relations. The bank does not charge for making these arrangements and hopes for the advantage of additional banking business or the possibility of obtaining marketable securities in exchange for those of privately held companies which may constitute trust assets of the bank's customers.

Consultants may be invaluable in planning a merger program. They may perform the staff work already discussed in evaluating the prospective purchaser's strengths and weaknesses, the establishment of criteria, and the performance of the search and screening tasks already outlined. In addition, through their detailed ac-

quaintance with particular industries, their relationships with past and present clients, and the fact that they are frequently sought out by buyers and sellers for assistance, they may know of promising situations and provide an entree for the new managers or owners of interested companies.

Investment bankers will often be a useful source of information about particular companies. Furthermore, an investment banker may be able to provide additional services which, in some cases, may be essential to the consummation of an acquisition. For example, where a public issue of stock or debt securities is required to finance the acquisition, the services of an investment banking firm will necessarily be required. Many investment banking firms also provide a service in placing securities privately with institutional type investors and also advise and assist in the negotiation of the terms involved in this type of financing arrangement. Often these firms maintain a department which specializes in this type of private financing and, in consequence, are in frequent contact with the various institutional lenders. They, therefore, are in a position to advise where the most favorable terms are likely to be obtained.

Some investment banking firms maintain departments which specialize in the evaluation of companies for purposes of merger and acquisition negotiations. The experience of such firms in valuation techniques and in designing a form of transaction so as to achieve the maximum flexibility may be quite helpful. Moreover, in many cases the company being acquired will be required to submit a proxy statement setting forth the terms of the proposed transaction to its stockholders. In preparation for such submission of proxy material it may be helpful to have the proposed terms reviewed by an independent financial adviser, experienced in similar transactions, with a view to the publication of an opinion in the proxy material as to fairness and reasonableness of such terms. Such an opinion is often a significant factor in minimizing the number of dissenting stockholders.

One possible source of information is the business broker. Unfortunately, there are some "bad" brokers whose practices of charging exorbitant fees for minimal service or who are not professionally competent taint an otherwise useful service group. Good brokers who are qualified and ethical make substantial contribu-

tions to corporate efforts to acquire, merge, or be bought. Some minimum caution and procedure should be mentioned to avoid the wrong kind of broker. Counsel may advise that brokers furnish written authorization of their service to a company for sale or merger, with a clear statement as the source of fee payment in the event of a successful negotiation. A log book or memorandum of broker contact is desirable in order to establish identity and date of initial disclosure.

By virtue of the service they provide, brokers are likely to be able to limit their acquisition suggestions to companies willing to negotiate. Thus, insofar as they generally deal in situations with which they are already familiar, business brokers may be more useful sources of information for an investment-type acquisition than for a "tailored" acquisition. Brokers may, however, be of use in search proceedings if they have sufficient knowledge of a given industry to work from the criteria established for the search. Brokerage firms are likely to be particularly useful where relatively small companies, in such fields as retailing, are sought. Brokers, of course, charge finders fees for their services, which are generally based on the purchase price of the company acquired, there are no standard fee schedules prevalent in the field, although fixed percentage fees are generally employed for small company acquisitions with a sliding scale of rates as the size increases. For finding large companies, the fee is subject to negotiation. Needless to say, the fee should be discussed with the broker in advance of his locating a prospect, and a firm agreement should be arrived at for the protection of both broker and client.

A further source of information on available companies is the advertisement. Responses to ads of this type generally produce large numbers of companies of no particular interest. Ads are inherently non-selective unless they state criteria in them and, if they do, the specialization of requirements may produce no results at all. Nevertheless, if the criteria to be met are broad ones, it may be worthwhile to place an ad, since the cost for ads in financial journals or trade periodicals is low in relation to the prospect of success.

If the acquiring company has good relations with a supplier or customer in the industry of interest, it may be able to obtain from

that source background information on the field and specific information on individual companies.

Beyond the information clearing houses, the prospective purchaser's personnel may furnish a valuable means of acquiring data. Members of the Board of Directors often have contacts in other industries which can be most helpful in the company's search. Such contacts should certainly not be neglected. They can be the first contact with the prospect, and they often provide a strong, social-business entree, as do certain bank officials and investment counselors.

If the acquiring company does business with the industry in which it is interested, the purchasing or sales personnel can be most useful in evaluating the strengths and prospects of particular companies and may be well acquainted with any rumors in the trade about willingness to sell.

The prospective buyer may be in a field technologically related to the one in which it wishes to make an acquisition. In this circumstance its research and development personnel are likely to be closely acquainted with the state of the art in the industry of interest and to know the relative technological positions of companies in that industry. This information can be of great interest in rapidly changing, research-oriented industries.

The information that is being sought through all these sources is likely to be of several kinds, and the importance attached to the various categories of information will vary greatly depending upon the objective of the acquisition. In every case, financial statements constituting both general profit and loss and balance sheet data are of interest. In addition, stock ownership, concentration of control of stock, and some data on the controlling owners of a closely held corporation are desirable.

A general acquaintance with the industry is necessary, including as much information as can be obtained on markets, applications for the products, importance of brands, sales data, and methods of distribution. The acquiring company will want to know the nature of competition in the industry and whether sales are made on a basis of price cutting, technological superiority, quality, or service associated with the product.

For particular companies, it will want to understand their manufacturing situations. Do they subcontract production? Are their plants modern? What is the degree of decentralization in production?

The companies' market position and reputation should be examined. It is not always easy for an outsider to determine whether a company has been dissipating its good will and is about to go into a decline. Nevertheless, it is vital to ascertain this. If a great deal is not known about an industry, it is generally desirable to conduct a full-fledged market study including interviews with the suppliers and the customers of the industry, as well as with associations and other generally informed persons. The expense for such a study is very small in relation to the amount of money risked in an acquisition.

For the Available Company

Having reduced its list of desirable acquisitions to a manageable number by study or by use of internal resources, the acquiring company must next ascertain which of the companies on the list is willing to entertain propositions. This problem is greatly complicated by the fact that even those companies interested in selling out consider it to their interest to make a show of reluctance to sell in order to strengthen their bargaining hands. It is not, therefore, always easy to determine whether a company might be amenable to persuasion or whether a first refusal is final. Further, unless the initial inquiries are handled with great skill they may result in annoyance to the ownership of the prospective seller.

Very few successful companies have not been approached with acquisition offers during the great wave of company consolidations since World War II. This has been particularly true during the seller's markets in companies which occur during bull securities markets. While the first few invitations to buy a company may be flattering, management or ownership is likely to find frequent offers an annoyance. Managements recognize that rumors of pending change of ownership can be extremely destructive to employee, customer, and supplier relations, and they therefore seek to avoid having large numbers of potential buyers calling on their offices.

The problem of identifying and then approaching the available companies is discussed in Chaper VIII, Approach and Exploration. In many instances availability will not become evident until direct contact and considerable exploration with management and/or owners has been carried out.

Chapter VIII

Approach and Exploration

The problem of approaching a potential acquisition is necessarily a delicate one. If it is not handled properly the entire relation between buyer and seller may be terminated at the first approach. In any case, the success of further negotiations is sometimes determined by the first efforts to discover whether a prospect is willing to negotiate. The central problem at this stage is to determine the proper person and the right approach.

Why Companies Sell Out

The owners and managers of many companies have never seriously considered the advantages of selling out or merging, or the disadvantages that may result from continuing to operate alone. Other companies are well aware of the advantages of selling. In either case, it behooves a prospective purchaser to be aware of possible advantages to selling out. If the prospective acquisition has not considered these reasons, they may be useful in persuasion. If the company is willing to sell, it is important that the acquiring company know why in order to evaluate both bargaining positions.

(i) Personal Reasons for Selling: The owners of closely held companies are frequently motivated by personal reasons, including estate and income taxes. It is axiomatic that, as a result of the tax structure in the United States, a large percentage of the people who have built up substantial estates have done so through the

growth of their own companies, and in these situations ownership and management are often vested in a single individual and his family. In such circumstances, when the owner-manager approaches retirement age most of his assets consist of stock in his own company. If no members of the immediate family have the interest or capability to take over management, the aging owner is likely to find that his estate will consist of shares without a ready market and that his death or retirement will remove the company's top management.

Frequently, the most feasible and attractive means of converting the assets into marketable shares is not to go public but rather to participate in a tax-free merger with a large, publicly held company whose shares are listed on an exchange. Ideally, the large company should be sufficiently diversified so that ownership of its shares has the stability and security of a diversified portfolio, since in these circumstances it is not necessary to sell the stock of the acquiring company and pay capital gains in order to achieve the safety of diversified investment. Banks are often highly influential in such situations in encouraging mergers. They recognize that, if the closely held company is likely to become a portion of an estate or trust of the owner-manager, their duties as executor or trustee place them in the untenable position of having either to obtain new management for the company, to manage it themselves, or to market the shares of the closely held company in order to produce a prudent investment portfolio. And if the bank is a commercial one, it will be quick to recognize that a company likely to be suddenly deprived of its top management is a rather risky loan prospect.

The estate tax is an added reason for an owner-manager to seek to diversify. If a family's assets are almost entirely in the stock of a closely held corporation, it may be extremely diffcult to raise sufficient cash to pay estate taxes, although relief may be available through the optional use, in certain circumstances, of the "installment" payment of estate taxes up to 10 years after due date (Sec. 6161), since the securities are not readily marketable and the amount of the estate tax cannot be known in advance because of evaluation problems. It is, of course, possible to minimize estate taxes by *inter vivos* transfers of shares to other family members. However, many owner-managers are reluctant to give up personal control of their companies by transfers to relatives during their lifetime. This

problem can be solved through a merger/acquisition by an arrangement in the sale or employment contract which gives the former owner participation in the management of his company as a subsidiary or division. Deals specifying payment in part from future earnings tend to perpetuate the key man's activity and interest.

Finally, irrespective of family or tax considerations, the owner-manager may simply want to retire and enjoy the fruits of his labor in his company, but he may be unable to find satisfactory management to replace him and may discover that his shares are not marketable at the value he wishes to place on them. Sale or merger of the company as a whole is, therefore, the obvious course.

(ii) Business Reasons for Selling: Beyond the problems of the closely held company with its primary objective to benefit a few interested parties, there are other problems that may beset any corporation. The technological advances of the last decade have put severe strains on many companies. Relatively small companies may find it next to impossible to match their larger competitors in research and development and in automation because of the capital and risk involved. Thus, there is a constant struggle to keep operations and products equal to those of wealthier firms which have the necessary money to modernize and to conduct product research. At this point in a company's history the handwriting is on the wall, and the best hope of salvaging the company is to merge it into a larger, more viable corporation which can provide the financial base and perhaps the volume of operations necessary to justify modernization or development.

A related problem is the shortage of working capital for expansion. This problem is most likely to beset relatively new companies whose earnings records do not justify large amounts of credit. The financing of the inventories, receivables, and selling and manufacturing employees needed for expansion becomes an acute problem and a difficult one to solve. Once again, merger or sale may provide the best means of providing the operation with the funds necessary to exploit its potential.

Competitive factors, including the R & D and modernization problems mentioned before, may also motivate a company to sell out. Through the natural process of evolution, or

through the entry of a very large company into the field, a competitor may appear with a decisive advantage. For example, a very large, multi-product manufacturer can pose a considerable threat to present single-product suppliers in any of a number of equipment lines because of the size and quality of its sales force and the fact that salesmen already calling on customers are in a position to sell a new piece of equipment without a substantial increase in selling costs. Since single-line producers do not have this advantage, the introduction by a major company of a new product can greatly increase the desirability of merging from the point of view of small competitors.

If a large company builds up its own distribution system it may pose a considerable threat to smaller competitors. By the same token, vertical integrations resulting in a single competitor having captive sources of raw materials or semi-finished products may put great pressures on other manufacturers in the same field, since the integrated producer may have the option of taking his profits at the earlier production stage and lowering prices on the end product.

Another common situation leading to the change of ownership of companies results when a serious disagreement on corporate policy arises among several large shareholders who participate in the management. If the disagreement goes deep enough and is bitter enough, the only means of resolving the problem may be for the disagreeing shareholders to liquidate their stock or convert it into the shares of the merging company.

Ownership may be more concerned with opportunities than with problems; the chance of giving up stock in a static though profitable firm for stock in a diversified firm with good growth prospects can be very attractive.

There are, of course, many variations on these themes and combinations of reasons for choosing to sell out. A thorough acquaintance with the prospect's situation is the best means of determining how best to make the approach.

Although the acquiring company usually makes a reasonably thorough study of the company to be acquired, the reverse is seldom true. Mergers in which parties make thorough evaluations

of each other have a much better chance for success by making possible creative input design to resolve post-merger problems in advance and by establishing mutual understanding and cooperation at an early stage.

Determining the Right Contact

By means of the previously mentioned information sources or others, it is generally possible to identify the best person or persons to talk to in the prospect company. These may be either the management or the ownership.

It will prove well worth the effort to bore as far as possible into the problem of determining who the "right person" is—who really controls the company as a decision maker. It may be the chairman of the board or president as in a widely held public company, or it may be the confidential adviser to the widow of the late president of a closely held company. Bankers, attorneys, community leaders, principal suppliers or customers may be sources of sound knowledge as to who makes the important decisions. Occasionally the initial contact should be made through a bank, i.e., if the control of the voting stock is in trust. In any case, however, the initial approach to the prospect should be regarded as a selling job. As such, it is desirable to work out a sales approach with at least as much care as would be given to the sale of a product or service.

Tailoring the Approach

Before making the initial approach, and after reviewing and preparing the personalized presentation story, the prospective purchaser should consider what the problems of the prospect are or are likely to be. If the company is closely held, estate tax problems and problems of liquidity are likely to be of deep concern to the ownership. An analysis of the company's financial statements may indicate a shortage of working capital. If the company is a small one in an industry of many large competitors, the costs of full-scale automation may be of great concern. The single-product line company may have difficulty with marketing inefficiencies if it is in competition with companies that have several product lines. Thus, the more one can learn about the industry and the prospect company, the better his chances of being able to discuss intelligently the prospect's problems. The demonstration of a real appre-

ciation for the needs of a company and the ways it can be assisted are likely to make the prospect more willing to continue discussions.

In addition to understanding the prospect's problems, the individual or team making the initial approach should be prepared to discuss the opportunities of the company's merging or being acquired. These opportunities will comprise means of solving the immediate problems, such as lack of working capital or single product line. And if the prospect has not seriously thought about merger/acquisition, reviewing the mutual advantages may be helpful. These advantages are the ones which the acquiring company hoped to accomplish when it set its objectives, and they might range from economies of scale to conversion from regional to national marketing.

In the initial contact, it is probably not wise to make firm commitments on specifics that might later be used as bargaining weapons. Nevertheless, the ability to discuss possible objections is likely to be helpful. Thus, for example, if an owner-manager wishes to continue to operate his company, it would be helpful to mention the various means by which the acquired company could preserve some autonomy and yet achieve the advantages of combination. The objective here, of course, is to arouse and retain enough interest on the part of the prospect so that he will agree to review his position and consider further discussions. By anticipating objections, the initial approach not only arouses the prospect's interest but also serves as a preliminary indication of matters of importance to the prospect. The points raised in the initial meeting are likely to be those uppermost in the prospect's mind. They are, therefore, likely to arise again during the formal negotiations. The prospective purchaser is thus forewarned and can decide what concessions it is willing to make in order to meet the prospect's objections.

Chapter IX

Evaluation

A major problem in completing a merger or acquisition is to establish a value for a cash purchase or an exchange ratio if payment is to be made in stock or other securities. In all except special cases, such as a purchase with the intention of liquidating assets, the potential future earnings are determinative. These earnings are, in one way or another, translated into a going concern value. This value is never absolute but a best judgment appraisal and the best that can be hoped for is to establish a range of negotiation within which a transaction can be consummated.

An offer by buyer will be the result of his judgment of a mass of financial and commercial information, objective or intuitive. The highest price in buyer's range, and which he may choose to call his evaluation peak, becomes the sum total of his optimism for the future earning power of the combined business enterprise which he envisions can result. There is no formula for arriving at this maximum, nor is there a universal or independent method of determining the seller's minimum price. The seller will have his own yardsticks for evaluation, such as the methods described in this chapter, tempered by the degree of competition which exists or which he can create for the purchase of his business. The electronics and food-processing industries during the past few years have been combed carefully by hundreds of financially strong buyers who, in many instances, have had their stock values so inflated by the eager market or who have had to pay fantastic prices

to reflect the optimisms for electronics and food processing companies as to set what might appear to be ridiculous values.

In any event, judgment, if it is to be based on reason, will recognize that competition can place momentary values on businesses which may evaporate as time goes on. In the anxiety to acquire, anticipated earnings will be exaggerated, but what is sound value, what added *costs* as well as savings will be necessary, how much will it really cost to integrate? Some base for determining values is needed to which adjustments and modifications can be made. The following information is directed to the problem of establishing some bases

The bases or methods are all financial. The extent to which the general corporate objectives and commercial considerations can be met through the acquisition/merger will increase or decrease the financial value. If, in addition to securing new products, an acquisition was intended to supply competent management candidates for leadership of the combined enterprise but no evident candidates are available, the transaction may still be acceptable but with a reduced price ceiling set.

There are many factors which will enter into the final judgment of total value, some of which can be financially appraised while others may be appraised intuitively.

Among these factors is "know how," a term commonly used to cover a multitude of situations. It would be impossible to discuss all of these, but a few examples might be helpful:

A company which stays ahead in a very competitive industry through its ability continuously to create machinery and equipment which allows it to produce a higher quality product more efficiently than its competition;

A sales force which has the ability to outsell its competition by making use of the company's engineering staff to give better service to its customers;

A research and development department which can constantly improve the company's product and thereby enable the company to stay in the forefront;

A market research staff which can analyze its company's markets and advise the sales force and research staff as to anticipated developments and thereby improve the profitability;

An advertising and promotion staff which, through creative ideas and the ability to translate these ideas into action, enables its company to merchandise, better than its competitors, a competitive standard product.

Another important factor is the opportunity of obtaining competent management which can, for the buyer, fulfill a need. An unusually competent executive, an outstanding sales force experienced in a particular market, a research staff well organized and complete with personnel, facilities and programs, or unusually competent plant management, are all examples of benefits which a purchaser may acquire through an acquisition.

Sometimes a company may be faced with the decision as to whether it should develop a product and a market for the sale of this product, or whether to acquire both through an acquisition. Effort, cost and time of developing the product and the market can be compared with the cost and effort of obtaining them through an acquisition. More often than not, it is beneficial to obtain these through acquisition and, in some cases, the benefit is so great that from the point of view of the buyer a higher price can be paid than would otherwise be justified.

All of these factors, together with others, will affect the ultimate decision as to whether the acquisition should be made and, if so, at what price. These factors should be used to adjust the base price determined through financial analysis.

Analysis of Operating Trends

Where past data are available it is essential to analyze performance to establish detailed trends which may be clues as to likely future performance or to spot possible fluctuations which can create results not noticed in overall trends.

A useful method of assembling data is to review the last five or ten year profit and loss statements, together with the detail to support the important elements of the statements. The data can be set up in absolute dollars by item of the statement and then by significant ratios as percentages. Without intending to be all-inclusive in mentioning the gamut of ratios which are applicable, the following examples of ratios for trend purposes may be helpful:

Operating Profit Margins
Selling and Advertising Expenses to Net Sales
Direct Labor per Sales Dollar
Cost of Goods Sold to Inventory
Sales to Receivables
General Expense to Sales
Material Costs to Sales
Maintenance and Repair Expense to Direct Labor

An important reason for studying significant trends is to provide subject areas for discussion with management. As trends or variations from trends appear in the analysis they may receive interesting explanations by management. If margin trends are down, what can management describe as a plausible reason for the optimistic earnings projection which it may have prepared? If maintenance or advertising expense ratios are trending off or have been precipitously reduced, can this be evidence of preparing the company for sale? If sales to receivables has been decreasing, has business been taken from risky customers in order to show higher sales volume?

A detailed layout of trends may serve as an excellent work sheet for directing specific inquiry and investigation.

Analysis of Accounting Methods and Procedures

Despite the fact that certified financial statements will say "in accordance with generally accepted accounting practices," this does not mean that the results obtained are determined on the same bases. In almost all accounting procedures there is more than one generally accepted method. Consequently, if comparisons are to be made of different companies, then adjustments of accounting procedures are usually necessary to bring the results on to a comparative basis.

Following are some of the major accounting methods and procedures, all of which are "generally accepted" but which may change the results obtained substantially.

Inventories: A good example of different results which can be obtained from the use of generally accepted accounting procedures is inventory treatment.

There are at least two generally accepted methods of accounting for inventories—LIFO (Last In—First Out) and FIFO (First In—First Out). Over a long period of time, the use of either method should theoretically produce the same result insofar as earnings are concerned. The fact is, however, that because of a history of continuous appreciation, the LIFO method has tended to increase costs and thereby decrease earnings when compared to FIFO.

A second and important difference in the accounting treatment of inventories is the costing method used. In some cases overhead and other costs are added to inventories rather than being charged directly to expense; different methods of determining the cost of manufacturing are used; raw materials may or may not include shipping costs. Consequently, to compare inventories, adjustments must be made in order that the results obtained are compatible.

Depreciation: Substantially different results can be obtained in computing earnings for any one year, depending upon whether the depreciation is computed on the basis of straight line, sum of the digits, double declining balance, and other generally accepted methods for computing the annual depreciation charge. Theoretically at least, over the life of the asset, the total depreciation charge will be the same but for any one year quite different results are obtained.

Even where companies use the same method of computing depreciation, other differences occur where the estimated life of similar assets vary, thereby changing the annual rate.

The cost basis of an asset varies according to whether such items as shipping costs, installation costs, tooling and other costs are included in the total cost of the asset.

Therefore, adjustments must be made in order that the comparison is a fair one.

Capitalizing and Expensing: Company policy as to which expenditures should be capitalized and which should be expensed can vary widely. This variation leads to different results as to the amount of earnings realized during any one year and can change the asset accounts on the balance sheet. This difference in policy is most usually found in such items as repairs, advertising and promotion, research and development, small tools and similar equipment expenditures, and many others. Careful analysis must be made of the similarity of treatment of such costs if earnings are to be compared.

Reserve for Bad Debts: The basis for computing reserve for bad debts varies from company to company and this sometimes leads to substantial differences in the earnings results.

Inclusion of Capital Gains in Earnings: Some companies include gain from the sale of assets in the current year's earnings while others credit such gains directly to surplus. If this difference is found, adjustment must be made to obtain compatible results.

Publicly Held vs. Closely Held Company Accounting: While the differences discussed above, as well as others, often exist in publicly held companies, these problems become more acute in closely held or family-owned companies where the opportunity exists for reducing taxes through a policy of keeping taxable income as low as possible. Usually an analysis of a closely held or family-owned company will show that the earnings are less, often substantially, than if the accounting policy of a publicly held company had been used.

Other Financial Differences: There are many other differences which require adjustment if a true comparison of the earning potential of two or more companies is to be made. Some of these differences are found in: standard costs methods, pension plans, stock option plans, labor contracts, vacation practices, employee welfare provisions, and many others. These are not problems which arise from the use of the various generally accepted accounting practices, but rather from basic differences in the method of doing business. All should be carefully analyzed in order that a comparison of one company with another is not distorted.

Analyses of these basic differences in the method of doing business are very important because it is in this area that difficulties arise when the attempt is made to assimilate one company with another. Sometimes, drastic measures are necessary in order that the comparison of results is a just one.

All these differences can, however, be reconciled and a value placed on them so that the analyst can arrive at a fair comparison.

There is another entirely different group of problems for the analyst to deal with when an attempt is made to forecast what the earning results might be if the two companies were melded together. These include such things as forecasting the savings to be obtained through combining sales forces, production activities, utilization of surplus capacity, combining research and development facilities, and many others. There are techniques available from which these problems can be solved. Many of these analyses require detailed work and considerable effort and while the results sometimes may be fairly obvious this important element in determining the feasibility of a merger/acquisition should never be overlooked.

Other studies which should be made include the cost or time lag in the market place of developing and promoting one's own product as compared to obtaining such a product already marketable through acquisition/merger. All these problems and most others lend themselves to analysis which will produce a financial answer. As a matter of fact, almost the only group of problems which do not lend themselves readily to financial answer are personnel problems such as: the reaction of the members of the sales staffs if they are to be combined; the reaction of executive personnel if a new president is being obtained through the merger or acquisition; the reaction of the labor force to a different union; and other similar problems.

There are times where the results are so obvious, or a need so pressing, that complete analysis of these more difficult problems is not necessary. Many companies, however, have been misled by the obvious and have paid no attention to the less obvious and, as a result, have entered into disastrous mergers or acquisitions when a study in greater depth would have revealed hidden problems that would have changed the outcome.

A fairly detailed case is described in Appendix G to illustrate some actual considerations of economies foreseen in a merger, future earnings estimated and adjustments necessary to make a comparable analysis of two companies.

Methods for Determining Value

Generally, going concern value is of most interest both to the buyer and the seller. However, other values such as book value and appraisal value should not be overlooked. Ultimately, all values may play a role in the final decision.

Book value alone is not a significant measure of the worth of a company because its basic function is to provide a means of establishing asset values for accounting purposes. These values are basically the original cost of the assets which may bear small relation to present cost or to the ability of the assets to produce earnings. Book value can be useful when properly analyzed as a basis for adjustments for computing the rate of return or the ability to produce earnings. It serves as a starting point for comparative analysis.

Book value is important, at least to many shareholders, as a measure of relative participation in the net worth of the company and for this reason, valid or not, becomes a factor in measuring the reasonableness of exchange of stock. Habitually, the pre-merger book value of a share is compared against the post-merger book value to measure dilution. While it would appear that increased per share earnings should be the true measure, a surprising number of corporate managements are concerned with dilution and it has not been unusual to find merger plans shelved because of a per share decrease in book values of combined two companies that would result.

Book value may be completely deceiving even for this purpose. A more realistic measure of participation in net worth would be to capitalize future earnings to secure true value and the difference between this and book value would represent goodwill.

Appraisal of Assets

This method is useful in conjunction with other methods but,

except in special situations, is not adequate because the appraisal value of the assets may have small relation to their ability to produce earnings. The important consideration in acquiring a company is the expectation of earnings as a going concern, and an appraisal does not accomplish this. It simply attempts to place a replacement or market value on each asset.

There are several advantages to having an appraisal of assets in a merger or acquisition. Where the acquisition may permit the reduction of accounting "goodwill" through the increased valuation of specific assets, the appraisal by independent appraisers can be helpful. A realistic and professional appraisal of both tangible and intangible assets not only serves for accounting and tax purposes such as allocation of purchase price to various assets, but is a check against results obtained through the use of other methods of determining going concern value.

An appraisal of assets often bears little relation to the productivity of such assets, but such an appraisal will tend to reveal strengths and weaknesses that might otherwise be overlooked. Of particular importance is the appraisal of patents, secret processes, franchise rights, partially completed research and development and other similar assets.

Inventories, accounts receivable and hidden liabilities should be analyzed with great care. Careful examination should be undertaken of inventory pricing method, depreciation procedures and other accounting policies in order to determine differences which may affect the earnings of a company as compared with another.

A good, professional appraisal is good insurance against expensive surprises later on.

Discounted Cash Flow

This is a term applied to a technique of calculating an interest rate which discounts an estimated future stream of earnings to a present value or investment. For example, a selected rate of interest, such as cost of capital or a subjectively assigned target rate of return, can be used to calculate a present value and this value used as a purchase price for a business. This technique can also

be used to determine deferred payment which would be equivalent to the purchase agreed upon.

Going Concern Value

This is the value of a mature company in operation and it is measured by the ability to produce earnings.

In determining going concern value the assumption is that future earnings are being bought and sold and so it is necessary to establish a worth of these earnings which will satisfy both buyer and seller.

Future earnings may be estimated, for this purpose, either by market and cost studies which would use the best objective data or business judgments available, or by using as a starting base the projection of past earnings adjusted by influences which have served to distort past performance. Some techniques used in applying past earnings as a means of projecting the future are described in the following sections. The techniques mentioned will be more or less useful depending on the extent to which the company performance has been reasonably normal. Instances where recent losses have been sustained would not permit the use of a projection base or the capitalization of earnings. These are special conditions on which appraised assets, for example, may be the base for valuation.

There are several methods of using past earnings to measure the future.

Capitalization of Earnings (Schedule 1, columns 2 and 4)

1. Average the earnings for a period of time, say five years, and then capitalize this average at an appropriate rate.[1] While this

[1] The assignment of a capitalization rate is ordinarily not an easy task. The best initial source is usually the price-earnings ratios accepted by the market for similar companies in similar businesses. These reflect both the risk inherent in the situation and the market's view of the future profit possibilities which the industry affords Whether the acquiring company is willing to accept the market's view on the subject is likely to depend upon the purposes of the acquisition. In a diversification situation, the acquiring company may very well be willing to accept a high price-earnings ratio and thus a relatively low return on its investment in order to participate in a growing field. If, however, the acquiring company's objective is to strengthen itself in its present line of business, it may be reluctant to dilute its earnings and its return on investment by purchasing a company that will produce a low yield in relation to the price paid for it.

Schedule 1

COMPARISON OF SIMPLE AVERAGE & WEIGHTED AVERAGE

Year	(1) Weight Factor	(2) Earnings Company A	(3) Weighted Earnings Company A (1) x (2)	(4) Earnings Company B	(5) Weighted Earnings Company B (1) x (4)
1957	1	65,000	65,000	135,000	135,000
1958	2	80,000	160,000	115,000	230,000
1959	3	105,000	315,000	105,000	315,000
1960	4	115,000	460,000	80,000	320,000
1961	5	135,000	675,000	65,000	325,000
Total	15	500,000	1,675,000	500,000	1,325,000
Average Earning ÷ 5		100,000		100,000	
Average Earning ÷ 15			111,667		88,333
Capitalized (10 times)		1,000,000	1,116,670	1,000,000	883,330

method is reasonably simple, it does not accurately measure earning capacity for the future. For instance, over a five-year period two companies may each have earned $500,000 and yet there can be a substantial difference in the present earning capacity of the two companies, as indicated on Schedule 1. Company A has, over the five-year period, shown a steady growth in earnings while Company B has shown a steady decrease. A buyer should expect to pay more, and a seller expect to receive more, for Company A than for Company B. If, however, the simple average of earnings is used, the price for the companies will be the same because the simple average shows an annual earnings of $100,000 for each company, or is capitalized at 10 times, a value of $1,000,000.

2. A more accurate result can be obtained by weighing the earnings to give more importance to the more recent earnings than to the earlier ones. This is accomplished by multiplying the most recent year's earnings by five (if a five-year period is used), the second most recent year by four, the third most recent year by three, etc., add the weighted figures, divide by the sum of the multipliers and capitalize the results (see Schedule 1, columns 1, 3 and 5). This method gives at least partial consideration to the different patterns of earnings. This method results in projected annual earnings for Company A of $111,667 or at 10 times, a

value of $1,116,670, as compared to those of Company B of $88,333, or, at 10 times, a value of $883,330.

Neither method one nor two gives any effect to the efficiency of the assets to produce earnings. This can be accomplished by computing the average rate of earnings produced by the assets applied to this purpose (productivity factor) and then projecting earnings by multiplying the assets applied at the end of the period by the average rate (it is assumed in Schedule 1A, that net worth is the same as the amount of net assets applied).

Company A — Schedule 1A

Year	(1) Net Worth Beginning of Year	(2) Earnings	(3) Weight Factor	(4) Weighted Net Worth	(5) Weighted Earnings
1957	750,000	65,000	1	750,000	65,000
1958	783,000	80,000	2	1,566,000	160,000
1959	823,000	105,000	3	2,469,000	315,000
1960	875,000	115,000	4	3,500,000	460,000
1961	933,000	135,000	5	4,665,000	675,000
Total	4,164,000	500,000	15	12,950,000	1,675,000
Average (÷5)	832,800	100,000			
Average weighted (÷15)				863,333	111,667
Productivity factor (unweighted) (100,000 ÷ 832,800)					12.01%
Productivity factor (weighted) (111,667 ÷ 863,333)					12.93%
Projected earnings (unweighted) (995,000 × 12.01)*					119,500
Projected earnings (weighted) (995,000 × 12.93)					128,654

Company B

1957	750,000	135,000	1	750,000	135,000
1958	813,000	115,000	2	1,626,000	230,000
1959	870,000	105,000	3	2,610,000	315,000
1960	922,000	80,000	4	3,688,000	320,000
1961	962,000	65,000	5	4,810,000	325,000
Total	4,317,000	500,000	15	13,484,000	1,325,000
Average (÷5)	863,400	100,000			
Average (÷15)				898,900	88,333
Productivity factor (unweighted) (100,000 ÷ 863,400)					11.58
Productivity factor (weighted) (88,330 ÷ 898,900)					9.83
Projected earnings (unweighted) (995,000 × 11.58)*					115,221
Projected earnings (weighted) (995,000 × 9.83)					97,809

* (Net worth at end of 1961 for each company was $995,000)

3. Determine the productivity factor of the net assets applied by averaging the net assets applied to operations for the period as well as the earnings, divide the average earnings by the average net assets, then multiply the productivity factor thus obtained by the most recent net assets applied to obtain future earnings and capitalize (see Schedule 1A). Here again, this can be a simple or weighted average. If a weighted average is used, the net assets must be weighted similarly to the earnings.

If a capitalization rate of 10 times earnings is used, Company A would have a value of $1,195,000 or $1,286,540 depending on whether a simple or weighted average is used while Company B's value would be $1,152,210 or $978,090 respectively.

The rationale of Method 3 (supplying the productivity factor) is that over a period of years the net assets applied have been producing at a certain rate and unless something is indicated to the contrary should continue to do so, and should do so on the latest amount of assets applied. When it is realized that there has been steady growth in earnings of Company A to reach $135,000 in 1961, then a projected earnings figure of $128,654 (see Schedules 1 & 1A) seems more realistic than the others obtained.

The computations on Schedule 1 serve not only to illustrate three possible methods of projecting future earnings from past earnings, and by capitalizing these earnings arrive at a value, but also illustrate the effect of weighing more recent earnings in projecting past earnings. The only reason for making a comparison is to show that over a period of time two companies may have the same average earnings and yet quite different earnings patterns.

Computation of Relative Value of One Company in Terms of the Other

Method 3 can be modified and used to determine relative values of two quite different companies.

Schedule 2 compares Seller Corporation in terms of Buyer Corporation and this and Schedule 2A set forth the pertinent information of the two companies. Subsequent pages show computations.

FINANCIAL DATA OF COMPANIES USED IN COMPUTATIONS IN SCHEDULES 2, 3, AND 4

Buyer Corporation is a privately owned company. The only stock outstanding is 205,000 shares of common stock having a book value as of December 31, 1961 of $70 per share.

The earnings and net worth as of December 31, for each of the most recent five years are:

YEAR	EARNINGS (000)	NET WORTH Dec. 31 (000)
1957	$2,100	$ 9,200
1958	2,500	10,400
1959	2,640	11,860
1960	2,390	13,180
1961	2,190	14,350

The net worth as of January 1, 1957 was $8,000,000. All the assets of the company were applied to operations.

Seller Corporation is a privately owned company. The only stock outstanding is 15,000 shares of common stock having a book value as of December 31, 1961 of $134.00 per share.

The earnings and net worth as of December 31, for each of the most recent six years are:

YEAR	EARNINGS (000)	NET WORTH Dec. 31 (000)
1956	$ 90	$1,090
1957	26	1,110
1958	235	1,270
1959	460	1,310
1960	575	1,630
1961	820	2,010

During the year 1957 the company suffered a bad fire which depressed earnings; an estimate showed the profits would have been $180,000 if conditions had been normal.

ACTUAL EARNINGS, 5 YEARS

BUYER CORPORATION

(000)

Year	Average Net Worth	Earnings	Multiplier	Weighted Net Worth	Weighted Earnings
1957	8,600	2,100	1	8,600	2,100
1958	9,800	2,500	2	19,600	5,000
1959	11,130	2,640	3	33,390	7,920
1960	12,520	2,390	4	50,080	9,560
1961	13,765	2,190	5	68,825	10,950
	55,815	11,820	15	180,495	35,530
Average	11,163	2,364		12,033	2,369
Productivity factor (unweighted) (2,364 ÷ 11,163)				.2118	
Productivity factor (weighted) (2,369 ÷ 12,033)				.1969	

SELLER CORPORATION

(000)

1957	1,100	26	1	1,100	26
1958	1,190	235	2	2,380	470
1959	1,290	460	3	3,870	1,380
1960	1,470	575	4	5,880	2,300
1961	1,820	820	5	9,100	4,100
	6,870	2,116	15	22,330	8,276
Average	1,374	423		1,489	552
Productivity factor (unweighted) (423 ÷ 1,374)				.3079	
Productivity factor (weighted) (552 ÷ 1,489)				.3707	

The average annual net assets applied (beginning net assets plus closing net assets divided by two) have been averaged for the five-year period as have earnings for each company. The average earnings have then been divided by the average net assets to determine the productivity factor. The difference in the productivity factors is determined by subtracting the lesser from the greater. The percentage by which the greater exceeds the lesser is obtained by dividing the difference by the lesser. The percentage of the excess is then multiplied by the most recent net worth of the company having the greater productivity factor to determine

the additional net worth necessary to produce the same earnings at the rate of the company having the lesser productivity rate.

Again, it is important to give effect to different earnings trends so it is suggested that in all cases the weighted averages more nearly approach realistic results than do simple averages. It should also be reiterated that the basis of these computations are past earnings, and certain adjustments may be necessary to avoid distortions. Such a situation arises in the illustrative example. Seller Corporation suffered a fire which severely depressed earnings during 1957. These earnings should be adjusted to a more normal level. This can now be done in at least three ways: (1) estimate earnings under normal conditions; (2) average the earnings for the prior year and the subsequent year and use the average to represent earnings for the year in question; and (3) disregard the year 1957 for both companies and use a four- instead of a five-year period. There may be, in any particular case, good reason for using a longer or shorter period.

Results of simple and weighted averages for five years, and for the four years without the distortion year 1957, are shown below.

Basis of Computation	*Number of Buyer Shares*
Actual earnings, simple average, 5 years	41,757
Actual earnings, weighted average, 5 years	54,057
Actual earnings, simple average, 4 years	50,529
Actual earnings, weighted average, 4 years	58,314

The sample details of one calculation are shown in Schedules 2 and 2A. The other calculations would follow the same general procedure.

It will be noted that from the point of view of Seller Corporation the results are conservative because at no time are the projected earnings equal to those realized during the last five years of actual experience while in each case the future earnings of Buyer Corporation are greater than those actually realized during the last full year.

These computations establish a range of negotiation from a low of 41,757 shares to a high of 58,314 shares. The low of 41,757 is unreasonably low and should not interest the stockholders of Seller Corporation because no consideration has been given to the profit growth experience by Seller Corporation or to the distorted

earnings for 1957. In fact, if one accepts the theory that consideration should be given to growth by weighting the earnings, the range falls between 54,057 shares and 58,314 shares.

Schedule 2A

Weighted Average	
Productivity factor of Seller Corporation	.3707
Productivity factor of Buyer Corporation	.1969
Excess	.1738
Per cent of excess in terms of Buyer Corporation (.1738 ÷ .1969)	88.27%
Net worth Seller Corporation, December 31, 1961	2,010
Adjustment for excess productivity (2,010 × .8827)	1,774
Adjusted net worth of Seller Corporation	3,784
Number of shares of common stock of Buyer Corporation @ book value of $70 per share ($3,784,000 ÷ $70)	54,057
Simple Average	
Net worth Seller Corporation, December 31, 1961	2,010
Productivity factor Seller Corporation	× .3079
Projected earnings	619
Divide by productivity factor Buyer Corporation	÷ .2118
Adjusted net worth	2,923
Number of shares of common stock of Buyer Corporation @ book value of $70 per share	41,757

For those analysts who prefer to make comparisons on the basis of projected earnings per share, a variation on the basic use of weighted net worth, weighted earnings, and corresponding productivity factors can be used. The projected earnings of both corporations are computed by multiplying the net worth of each for December 31, 1961 by its productivity factor, then dividing the projected earnings for each by the number of shares outstanding, then computing the ratio per share of one in terms of the other and finally computing the number of shares of the Buyer in terms of the Seller by applying the ratio. The results of these computations will be the same as shown in the above summary. Schedule 3 shows a sample computation for the actual earnings, weighted average, 5 years.

The next step in the evaluation is to compare the participation of the shareholders in the post-merger company in relation to the pre-merger status (see Schedule 4).

Schedule 3

WEIGHTED ACTUAL EARNINGS, 5 YEARS

Weighted Average

Net worth Buyer Corporation, December 31, 1961	14,350
Productivity factor (See Schedule 2)	× .1969
Projected earnings Buyer Corporation	2,826
Earnings per share (2,826,000 ÷ 205,000)	13 79
Net worth Seller Corporation, December 31, 1961	2,010
Productivity factor (See Schedule 2)	× .3707
Projected earnings Seller Corporation	745
Earnings per share (745,000 ÷ 15,000)	49.67
Number of Buyer Corporation common stock equal to one share Seller Corporation common stock (49.67 ÷ 13.79)	3.602
Total number Buyer Corporation shares (15,000 × 3.602)	(Approx.) 54,057[1]

[1] In order to arrive at exact and equal amounts in both Schedules 2 and 3 and to give answers to the closest share, the calculations should be carried to more significant decimal places

Schedule 4

COMPARISON OF POST MERGER EARNINGS AND BOOK VALUES

	Actual Earnings, simple average		Actual Earnings, weighted average	
	5 years	4 years	5 years	4 years
1. No. of Shares Paid	41757	50529	54057	58314
2. Total Shares After Merger	246757	255529	259057	263314
3. Per Share Net Worth	$ 66.30	$ 64 02	$ 63.15	$ 62.13
4. Per Share Increase (Decrease) Buyer	(3.70)	(5.98)	(6.85)	(7.87)
5. Equiv. Per Share Seller	184.57	215.66	227.58	241.54
6. Per Share Increase (Decrease) Seller	50.57	81.66	93.58	107.54
7. Earnings Per Share	12.20	11.78	11.62	11.43
8. Increase (Decrease) Buyer	1.51	1.09	.93	.74
9. Equiv. Per Share Seller	33 95	39.68	41.88	44.44
10. Increase (Decrease) Seller	(20 71)	(14.98)	(12.78)	(10.22)

NOTE—The book values per share as of December 31, 1961 and the earnings for the year ending December 31, 1961 were used as basis of comparison.

Buyer Corporation Per share book value was $70.00 and earnings were $10.69
Seller Corporation Per share book value was $134 00 and earnings were $54 66

Line (1) See text for derivation of # shares paid
Line (2) Line (1) plus 205,000
Line (3) (14,350,000 plus $2,010,000) ÷ Line 2
Line (4) Line (3) less $70
Line (5) Line (1) x Line (3) ÷ 15,000
Line (6) Line (5) less $134
Line (7) ($2,190,000 + $820,000) ÷ Line (2)
Line (8) Line (7) less $10.69
Line (9) Line (1) x Line (7) ÷ 15,000
Line (10) Line (9) less $54 66

The shareholders of Buyer Corporation had a per share book value of $70 as of December 31, 1961 which earned during the year 1961, $10.69. The shareholders of Seller Corporation had a per share book value of $134 as of December 31, 1961 which earned $54.66 during the year 1961.

Several selected exchange ratios of Buyer Corporation stock to that of Seller Corporation have been used to compute the after-merger results in terms of book value as of December 31, 1961 and earnings for the year 1961. In each case the shareholders of Buyer realize increased earnings and decreased book value, while the shareholders of Seller experience the opposite result.

It may be necessary to create a new class of voting common stock or to make part payment with bonds, preferred stock or other security with increased earnings participation and decreased book value to satisfy the Seller shareholders.

The method of using productivity of applied assets as one means of determining going concern value, and the accompanying computation, uses a simple set of facts but does present a starting point in the development of going concern value. Depending on the particular situation, modifications and adjustments must be made to make the formula usable. The results obtained should be compared with determinations arrived at from other methods. A discussion of modifications and adjustments seems pertinent.

On the particular set of facts used in the computations presented, net worth and net applied assets are the same. However, in many instances this is not so and in such instances adjustments must be made. A company will often have more working capital than is needed for the level of operations and this excess will be invested in securities of one kind or another. Whenever this occurs, such excess should be deducted from the net assets to arrive at net assets applied, and the income from such investments should be deducted from earnings in order to arrive at the actual net assets applied to operations and the actual earnings derived therefrom. Other examples of such applicable assets are idle plant and equipment, excess land held for investment or the ownership of a golf course.

Another modification which probably should be made is to use whatever other basis the Buyer company uses to determine efficiency of operations instead of net assets applied. The use of gross investment rather than depreciated value is a matter of judgment, but the formula lends itself to the use of either. There are several different bases, but so long as both companies are compared on bases that are compatible the results should be accurate.

Whenever better information on future earnings is available, from market studies or other sources, this information can be used so long as accurate information on the applied assets to produce the earnings can be developed. This eliminates the need for a projection of earnings based on the past.

It is important to remember that wherever a comparison is to be made the information used should be compatible for all the companies concerned. This may require adjustments in methods of depreciation and amortization, in methods of pricing inventories, in methods of evaluating patents and in other accounting procedures which may differ one from another.

A selling corporation with no established price for its stock can, by determining the comparative productivity of the assets, arrive at a ratio between its stock and the buyer's stock and, by applying the price of the buyer's stock on the ratio obtain a cash value for its company.

Any formula used to develop going concern value must, at some point, give effect to relative age and condition of plant and equipment, differences in stock option, pension and profit sharing plans, union contracts or the lack thereof, and other differences which may have to be reconciled in order to predict how such differences will affect the post-merger earnings and cash flow. It may well be that one of the reasons for the greater productivity in Seller Corporation is the failure to maintain properly its equipment which may require large sums of money in the near future for repairs and replacements.

All the assets of the company were applied to operations.

Stock Exchange Ratios

Another basis for comparing the comparative worth of two

companies is the comparative stock prices in the open market. If the stock of both corporations is listed and widely traded, an approximate exchange ratio can be established on the basis of market values. Presumably, the market value reflects such factors as prospects, stability and risk. Because of shareholder reaction, it is unlikely that a merger can be accomplished at a ratio that differs greatly from market value. However, since market value can often be distorted by such factors as dividend policy, it cannot often be used directly in establishing an exchange ratio.

The principal concern of both parties to a stock exchange is likely to be that earning power is not diluted in the consummation. Ordinarily, the stock exchange ratio tends to approximate the earning power of the two corporations. Variations can, however, be introduced to compensate shareholders for loss of earning power and to adjust for differences in asset valuation. The influence of increased market value is shown in the remainder of this section. Further it is possible to adjust differences in asset valuations by the use of senior securities and to use common stock as compensation for earning power.

Mechanics of Computations: The mechanics involved in determining a stock exchange ratio valuation are relatively simple. It is necessary only to obtain the market price per share of common stock, the dividend rate, and the earnings for the last full year. A few calculations from these data will readily indicate the appropriate ratio for a stock exchange with resultant equal values between the two companies' common-stock market price, dividends, and earnings, and in some cases, book value.

Schedules 5, 5A and 5B illustrate in detail the calculations necessary to arrive at the exchange ratio most likely to be accepted by both companies.

Schedule 5 shows how hypothetical Company "B" (buyer company) interested in acquiring Company "S" (seller company) might develop *pro forma* financial results based on various test ratios. The testing process would continue until the ratio most closely equalizing the stock values of the two companies is determined. In the illustrated example, six ratios are used ranging from a basis of 10 shares of "B" for 10 shares of "S" through 13 shares of "B" for 10 shares of "S." The most likely exchange ratio would be on the basis of 12½ shares of Company "B" for 10 shares of Company "S."

Schedule E

FINANCIAL RETURN TO COMPANY "S" STOCKHOLDERS

	PRESENT		PRO FORMA					
	Company "B"	Company "S"	10 Shares Company "B" for 10 Shares Company "S"	11 Shares Company "B" for 10 Shares Company "S"	11½ Shares Company "B" for 10 Shares Company "S"	12 Shares Company "B" for 10 Shares Company "S"	12½ Shares Company "B" for 10 Shares Company "S"	13 Shares Company "B" for 10 Shares Company "S"
Market Price	$50.00	$60.00	$50.00	$55.00	$57.50	$60.00	$62.50	$65.00
Dividend	$ 1.80	$ 3.00	$ 1.80	$ 1.98	$ 2.07	$ 2.16	$ 2.25	$ 2.34
Earnings Per Share—Last Full Year	$ 3.31	$ 4.18	$ 3.31	$ 3.64	$ 3.81	$ 3.97	$ 4.14	$ 4.30
Number of Shares Required—Company "B"		719,000[a]	719,000	790,900	826,850	862,800	898,750	934,700
Total Number of Company "B" Shares After Take Over	5,878,000		6,597,000	6,668,900	6,704,850	6,740,800	6,776,750	6,812,700
Dividend Payment		$2,157,000	$ 1,294,200[b]	$ 1,423,620[b]	$ 1,488,330[b]	$ 1,553,040[b]	$ 1,617,750	$ 1,682,460[b]
Retained Earnings		$ 851,000	$ 1,713,800	$ 1,584,380	$ 1,519,670	$ 1,454,960	$ 1,390,250	$ 1,325,540
Earnings Last Full Year	$19,456,180[a]	$3,008,000	$22,464,180	$22,464,180	$22,464,180	$22,464,180	$22,464,180	$22,464,180
Earnings per Share			$ 3.41	$ 3.37	$ 3.35	$3.33	$3.31	$3.30
Market Appreciation to Company "S" Stockholders			$(10.00)	$(5.00)	$(2.50)		$2.50	$5.00

[a] Company "B" shares presently outstanding.
[b] Based on Company "B" dividend rate of $1.80.

Assume I—Merger on basis of earnings
Assume II—"B" company adjusted dividend rate so that merged retained earnings would be the identical—in other words the merged company would pay out the same total dollars of dividends by increasing the present "B" company $1 80 rate. The new rate would be $1.87.

	Shares at Present *(thousand)*	Present Dividend Rates	Dollar Disbursement *(thousand)*	New Shares at 13 for 10 ratio *(thousand)*
"B" company	5,878	$1.80	$10.580	5,878
"S" company	719	3 00	2,157	935
			$12,737	6,813

A. Rate per new share ..... $12,737 ÷ 6,813 ... = $1.87
B. Dividend per old "S" company share. ... . $1.87 × 1.3.. .. = $2.43
C. Deficiency per old "S" company share..... $3.00 less $2 43... .. = $ .57
D. Theoretical market price increase of "B" company stock... .. .. .07 ÷ $1.80. . . = 3.89%
E. Theoretical new market price of "B" company based on Jan. 2 closing of $50..... ... . = $52
F. Theoretical market price of "S" company at 13 for 10 ratio ... . (13 for 10 at $50 = $65). .. = $67½
G. Market price "S" company Jan. 2 closing.. ..... = $60
H. Theoretical appreciation per "S" company share..... = $7½
I. Market appreciation equals over 13 years dividend deficiency on "S" company stock
J. Advantages to "B" company stockholder with 100 shares—
Theoretical price appreciation..... ... . = $200
Additional annual dividend..... .... = $7

On this basis of exchange, "S" shareholders would receive less in the way of earnings, and dividends would be considerably lower than those received prior to the exchange. An offsetting factor, though, would be the immediate $2.50 per share increase in market value of their stock. If market price of Company "S's" common stock is dependent upon a high dividend rate, some adjustments would have to be made.

The 12.5:10 exchange basis would also most likely be acceptable to Company "B" stockholders, since earnings per share would remain exactly the same and no dilution would take place.

From the basic calculations many adjustments can be made to make the acquisition more acceptable to the stockholders of

Assume I—Merger on basis of earnings (13 shares of "B" company for 10 shares of "S" company)
Assume II—"B" company adjusted dividend rate to $2.00 per share.

	Shares at Present *(thousand)*	Present Dividend Rates	Dollar Disbursement *(thousand)*	New Shares at 13 for 10 ratio *(thousand)*
"B" company	5,878	$1.80	$10,580	5,878
"S" company	719	3.00	2,157	935
			$12,737	6,813

A. "S" company earnings can almost pay the increased dividend

Dividend on merged shares (thousands).....6,813 @ $2.....	$13,626
Dividend on present "B" company shares @ $1.80.....	10,580
Additional dividends to be paid after merger....	$ 3,046
Profits of "S" company—1958.....	3,008
Additional charge against "B" company.....	$ 38

B. Dividend per old "S" company share..... ....$2.00 × 1.3 .... = $2.60
C. Deficiency per old "S" company share.....$3.00 less $2.60..... = $ .40
D. Theoretical market price increase of "B" company stock.....
..... .20 ÷ $1.80..... = 11.1%
E. Theoretical new market price of "B" company on Jan. 2 closing of $50 = $55½
F. Theoretical market price of "S" company at 13 for 10 ratio.....
....(13 for 10 at $50 = $65)..... = $72⅛
G. Market price "S" company Jan. 2 closing..... = $60
H. Theoretical appreciation per "S" company share..... = $12⅛
I. Market appreciation equals over 30 years dividend deficiency on "S" company stock
J. Advantages to "B" company stockholder with 100 shares—
Theoretical price appreciation 100 × $5.50 (55½ — 50)..... = $550
Additional annual dividend... ..... = $20

either or both companies. For example, Schedule 5A illustrates the adjustments and calculations necessary to make the basis of acquisition more attractive to both parties. Schedule 5B illustrates the mechanics involved for making the basis of acquisition still more attractive.

One purpose of this chapter has not been to lay down a hard and fast rule for determining going concern value but, rather, to present possible methods which can be used as a basis for computation and which are flexible enough to be modified and adjusted to a variety of different situations.

Chapter X

Legal, Tax, and Accounting Considerations

There are myriad business and governmental factors that influence the selection of the form of acquisition. These factors include, in part, statutory and regulatory requirements, accounting techniques, and the impact of taxation. A study of alternative forms of acquisition should indicate which forms are best suited to particular situations. Highlighted in this section, then, are the definitions of various forms of acquisition, the considerations involved in their selection, and the advantages and disadvantages of each. Some specific comments regarding antitrust aspects are also included.

The definition of the form of acquisition depends upon the viewpoint of the individual providing it. A lawyer's definition, purely legal, differs considerably from that of an accountant. Both definitions differ from that provided by someone looking at the acquisition solely from the tax standpoint.

Under various laws the form chosen can have profound effects on both buyer and seller, their customers, creditors, stockholders, and employees. The attractiveness of a given agreement can be influenced as much by the tax form and the tax consequences as by the "price" negotiated. And the form of an acquisition determines the type of accounting system that will be used by the merged corporation.

The Legal View

From a purely legal point of view, acquisitions may be divided into four categories: a statutory merger, a consolidation, a contractual purchase of assets, and a stock purchase. The brief descriptions of the four forms are given below and are discussed further in "The Tax View" part of this chapter.

(i) Definitions

Statutory Merger: The joining of two or more business firms through the direct acquisition by one of the net assets of the other or others by execution of a merger agreement in accordance with the statutory requirements of the state or state governments concerned, with the acquiring corporation surviving.

Consolidation: The combination of two or more business firms through the transfer of their net assets to a new corporation organized for the purpose, by execution of a consolidation agreement in accordance with the statutory requirements of the state or state governments concerned. In a consolidation, a new corporation or entity acquires the net assets of the combining units. Neither of the original corporations survives.

Purchase of Assets: The transfer of assets, for some monetary unit, from one business firm to another by deed or bill of sale. In circumstances where the acquiring corporation gives stock for assets the selling corporation generally liquidates. It may, however, elect to remain in existence as a holding company with the hope of merging into a mutual fund. This avoids the double tax problem.

There are intervening problems in this course, however. These include: questions of whether the company is a personal holding company or an investment company for tax purposes; questions of how to eliminate public stockholders if they do not wish to participate (in cases where such dissenting stockholders do not hold too large a percentage of the shares, a tenure offer may solve the problem); problems of the tax consequences of unrealized appreciation of assets when the holding company merges into the mutual fund. In any case, the holding company must operate for at least two

years to avoid serious tax consequences to its stockholders in liquidation. Both corporations survive.

Stock Purchase: The transfer of stock, for some monetary unit, resulting in control of a particular business by the purchaser. Both corporations survive.

(ii) Considerations

The factors involved in the choice of a form of acquisition are always the same. Depending upon the circumstances, however, certain factors may carry more weight than others.

Major factors to consider when determining the legal form of an acquisition are given below.

Antitrust:[a] The major consideration here is usually the legality of the acquisition under the antitrust laws. This consideration is, of course, always present regardless of the form of acquisition used. In respect to the choice of form, one must be aware of the possible existence of past violations of antitrust laws, i.e., the Robinson Patman Act and the Sherman Act. Any form of acquisition other than a purchase of assets may incur such prior antitrust liabilities. Form is of no consequence under Section 7 of the Clayton Act which deals with the antitrust results of the merger, and a purchase of assets is no protection against that section.

Appraisal Rights of Stockholders: With respect to mergers, consolidations, and some assets sales,[b] each state has enacted laws (commonly known as "appraisal statutes") which permit dissenting stockholders in such transactions to have their stock appraised and paid for by the company. In mergers and consolidations, dissenting stockholders of all corporations involved may have appraisal rights, but in an assets sale such rights are usually only associated with the selling company. Should too many stockholders demand appraisal rights, the drain upon a firm's cash can have adverse effects. This problem can be avoided by providing in the contract

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[a] For details concerning antitrust requirements and implications, see discussion of the Federal Trade Commission, and The Justice Department in the Appendix.

[b] If assets are purchased for stock, appraisal is not required unless the stock is listed on an exchange and over 20% of the listed stock is involved.

that the offer may be withdrawn if more than a given percentage of shareholders demand appraisal rights (e.g., over 5%).

Approval: Mergers, consolidations, and some assets sales require, by state statutes, the approval of the board of directors and the stockholders. In some states the consent of the majority of the outstanding shares is required, while in others two-thirds or three-fourths must approve. In addition, companies regulated by various governmental agencies (both federal and state) must also secure approval from such regulatory agencies.[a]

A few states do not permit the merger or consolidation of domestic corporations with corporations of other states, and some have statutes prohibiting mergers or consolidations of banks, insurance companies, and utilities with similar business firms. The legality of a particular acquisition should be verified before time and money have been spent.

Bulk Sales Requirement: Each state has enacted a bulk-sales statute designed to prevent the defrauding of creditors by the secret sale in bulk of substantially all a merchant's stock of goods. Negotiations in an assets acquisition must, therefore, be made public after agreement has been reached. A company desiring to keep such acquisition a secret over a long period of time might better choose a stock purchase, merger or consolidation.

Contracts Nonassignable: Franchises, deferred compensation plans, employee benefit plans, employment contracts, insurance policies, leases, licenses, mortgages, terms of bank loans, etc., may or may not be assignable. When such contractual obligations are nonassignable but are desired by the buyer company, a merger, consolidation, or stock purchase provides the necessary acquisition form. Conversely, when such contracts are adverse to the transaction, purchase of assets is desirable. Of particular importance in this connection are the employee benefits, pension plans, and stock options. The take-over of such plans could involve considerable expense. Under certain conditions, dependent upon the pro-

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[a] The requirements of various regulatory agencies are outlined in the Appendix A.

visions of a particular contract, even a merger or consolidation may not be advisable.

Corporate Identity: It may be desirable for the acquiring company to preserve the seller's corporate identity, especially when the selling company has a stock exchange listing desired by the purchaser. The possibility of retaining the listing is, however, subject to the decision of the stock exchanges. The New York Stock Exchange is less likely to allow retention than is the American Stock Exchange.

A few other reasons which can be equally important, depending upon the circumstances, are:

1. The preservation of a well-known name to enhance the possibility of capitalizing on previous advertising expenditures
2. Ready acceptance in the community
3. Local pride
4. Employee morale
5. The retention of any special favorable provisions found in the corporate charter of the acquired company.

If the preservation of the seller's corporate identity is of major importance, the only form of acquisition which can be considered is a stock purchase. The first four of these objectives can, however, be accomplished by using a slightly varied version of the selling corporation's name for the merged companies; e.g., the J. J. Smith Company, Inc. might become J. J. Smith Corporation.

Costs: In addition to the actual price paid to the seller when consummating an acquisition, there are other related expenses which can be of significance in the consideration of acquisition form.

When undertaking purchase of assets, the possibility and/or size of state sales taxes and documentary stamp taxes due on the conveyance of real estate must be considered. Added expenses in connection with such an acquisition may arise from possible duplication of federal old age insurance payments, motor vehicle licenses, and other state license fees, etc., when purchase takes place in mid-year.

A merger or consolidation where new stock is issued will result in federal stamp taxes on such newly issued shares. In an acquisition of this type further costs result from the expense of having numerous papers certified. Expenses of this type are also heavy in a stock-for-stock exchange. The cost associated with a stock purchase is usually restricted to the stock transfer taxes. If the transaction is handled through an investment banker, however, there will be brokerage commissions as well. If fees to intermediaries are involved, it is preferable to make them an obligation of the selling corporation since, if the seller declares a liquidating dividend (which would be taxable to its shareholders as ordinary income to the extent of earnings and profits), the cost of the fee is set off against ordinary income.

For all forms of acquisitions, there are the expenses involved in the actual search for and the evaluation of the company to be acquired; i.e., accountants, brokers, lawyers, and finders fees, but these costs rarely if ever have any effect upon the form of acquisition.

Employee Insurance Ratings: A stock purchase will automatically preserve the seller's experience ratings under the employee insurance laws—unemployment compensation and workmen's compensation. Such ratings will be definitely lost in purchase of assets and possibly be lost in a merger or consolidation.

Minority Block: In an acquisition which utilizes the stock purchase form, there is always the possibility that a minority voting block will be created if the stockholders of the selling corporation fail to act unanimously. This danger is nonexistent in a merger, consolidation, or assets purchase.

This problem can be avoided by making a minimum acceptance (e.g., by 30% of the stockholders) a condition precedent to the contract of sale. Further, in a sale of assets, dissenting shareholders can be forced out if the seller can vote 2/3 of the shares.

Paperwork and Time: A stock purchase involves the least paperwork and is usually the quickest and simplest form of acquisition, but it has a drawback, however, if the company to be acquired has a large number of stockholders. Under such conditions, an assets sale may be quicker, although there is a great deal of

paperwork associated with assignments, bills of sale, deeds, etc. Mergers and consolidations are by far the most time-consuming and complicated.

Seller's Liabilities: The acquiring corporation automatically becomes responsible for the seller's liabilities when the acquisition takes the form of a merger, consolidation, or stock purchase. Where the two companies are combined, unknown liabilities, i.e., past violations of antitrust laws, possible false or fraudulent tax returns filed by seller, litigation pending or threatened, liens, etc., can be avoided by using an assets sale.

Transfer of Assets: The transfer of assets is automatic in a merger, consolidation, and stock acquisition. When there is no objection to the acquisition of an asset or group of assets belonging to the selling corporation, any acquisition form will suffice. If the acquisition of an asset or assets is not desired, i.e., company yacht, unfavorable union contracts and employment contracts, pension plans, stock option plans, etc., then an assets sale is the better form.

Before favoring purchase of assets over an acquisition form, where the transfer of assets is automatic, the purchaser should consider the possibility that unwanted assets may be spun-off.

The Tax View

From a tax viewpoint, transactions involving corporate acquisitions fall into two principal categories: (1) tax-free and (2) taxable.

"Tax-free" acquisitions involve giving the sellers some stock interest in the acquiring or consolidated corporation. Recognition of taxable gain or loss to the sellers on the transaction is deferred, at least in part, until they dispose of the stock received. The tax basis of the assets carries over into the hands of the emerging corporation and so, in general, do the various tax attributes of the old corporation.

Taxable acquisitions, on the other hand, involve recognition of gain or loss to the sellers. Usually, the acquiring corporation gets a new tax basis for the assets received and the tax attributes of the former owner are lost.

Businesses presently owned in noncorporate form (e.g., partnerships and proprietorships) ordinarily can only be the subject of taxable acquisitions. This book will not discuss the complex problems which may arise when either the seller or the buyer is a partnership.

The tax effects for both seller and purchaser will be discussed hereafter in connection with a more detailed description of the various types of acquisitions.

(i) Tax-Free Acquisitions:

Types of Acquisitions: Section 368 of the Internal Revenue Code describes three types of corporate acquisitions which are tax-free (or more accurately, tax-deferred): (a) a statutory merger or consolidation (section 368(a)(1)(A)); (b) an exchange of stock for stock (section 368(a)(1)(B)); (c) an exchange of stock for assets (section 368(a)(1)(C)). These various types of reorganization will be referred to herein as type (A), (B) and (C), respectively. A fourth type, described in sections 368(a)(1)(D) and/or 351, involves the ownership, after the transaction, of at least 80 per cent of the stock by the transferor corporation or its shareholders. This type will not be described in detail, as it is seldom used, since normally a smaller company is acquired by a larger one.

A—Statutory Merger or Consolidation: An (A) type reorganization is a merger or consolidation effected under the corporation laws of the United States or any state or territory thereof. The courts have added the requirement that the stockholders of the predecessor corporation must receive a continuing proprietary interest in the surviving corporation, which interest must be substantial in relation to the assets transferred. The proprietary interest may be in the form of either voting or nonvoting stock (voting stock is required for types (B) and (C)). Debt securities (but not short-term notes) may be received tax-free only to the extent that an equal face amount of similar securities of the acquired corporation are surrendered.

B—Exchange of Stock for Stock: A (B) type reorganization is an acquisition of 80 per cent or more of the stock of a corporation, in a single transaction or a series of transactions taking place in a short period of time, solely in exchange for voting stock of the

acquiring corporation. If any cash or property other than voting stock is given, even for less than 20 per cent in value of the acquired corporation, the Supreme Court has ruled that the transaction is taxable. For this reason cash payments, even for fractional shares, should be avoided where a (B) type reorganization is effected.

C—Exchange of Stock for Assets: A (C) type reorganization occurs when a corporation acquires "substantially all the properties" of another corporation, in exchange solely for its voting stock, or voting stock of its parent. In determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other is disregarded, as is the fact that property is acquired subject to a liability. The meaning of "substantially all the properties" varies with the circumstances. The Treasury has approved one case as qualifying for tax-free treatment wherein the transferor retained 30 per cent of its assets (represented by cash), accounts receivable and three per cent of the inventory, to pay liabilities. On the other hand, in cases in which dissenting stockholders demand cash, the Treasury usually requires that at least 90 per cent of the assets be transferred to the acquiring corporation.

Section 368(a)(2)(B) provides a limited exception to the rule that solely voting stock of the acquiring corporation must be given in a (C) type reorganization. If 80 per cent of the fair market value of the property is acquired for voting stock, cash or other property may be given for the remainder. However, liabilities assumed or to which the property is subject are not disregarded for this purpose, but are treated as if an equivalent amount of cash had been paid out by the acquiring corporation. This latter provision makes it difficult to comply with section 368(a)(2)(B), and consequently the provision is seldom used.

(ii) Considerations Common to All Types of Tax-Free Exchanges:

Desirability of Advance Treasury Ruling: Both the statutory and the case law, and the procedural requirements dealing with tax-free corporate acquisitions, are quite complicated and an incorrect interpretation of the law or a procedural misstep can result in failure to qualify the transaction for the desired tax results. Disqualification of the transaction can mean the loss of the tax

benefits which the taxpayers had hoped to gain by the tax-free acquisition, such as carryover of predecessor's tax basis and nonrecognition of gain on the exchange.

To obviate the risk that the tax benefits will be lost as a result of a procedural misstep or misinterpretation of the law (which is subject to future interpretation by the courts), taxpayers often find it useful to apply to the Treasury for an advance ruling as to the tax consequences of a proposed transaction. Where a foreign corporation is a party to the transaction, section 367 requires that an advance ruling be obtained if gain is not to be recognized; where all the corporations are domestic the law permits such nonrecognition in a proper case even if no ruling is obtained.

If the Treasury issues a favorable ruling, the proposed transaction can be undertaken with the assurance that, if the request has stated the facts accurately and the procedures proposed were actually followed, the desired tax consequences will result from the transaction.

Business Purpose Is Required: A "sound" business purpose for the corporate acquisition, other than the avoidance of federal income taxes, is required if a transaction is to qualify as a tax-free exchange. Thus, a tax-free reorganization which meets all the technical requirements of the Internal Revenue Code may be challenged and disqualified on the grounds that the acquisition was a sham transaction, having no sound business purpose.

Substance, As Well As Form, Must Qualify: The rule of form vs. substance is applied to determine compliance with the rules of corporate reorganizations. Thus, if in an (A) reorganization, collateral or subsequent transactions not included in the formal plan materially alter the interests of the shareholders of the merged corporation in the continuing corporation, the courts have found that, in substance, all the transactions were part of a plan disqualifying the transaction for tax-free treatment.

Similarly, if in a (B) type acquisition the exchange of stock is only one of a series of steps in an integrated plan which does not qualify, such as a transfer of less than substantially all the assets of a transferor corporation for a noncontrolling stock interest in an-

other corporation, the transaction will be held not to qualify for tax-free treatment.

Transfer of Acquired Assets to Subsidiary: Properties acquired in an (A) or (C) acquisition may be transferred by the acquiring parent corporation to a subsidiary corporation without disqualifying the transaction for tax-free treatment. However, if in a (B) type acquisition the parent corporation transfers the acquired stock to a subsidiary, the Treasury holds that the subsidiary is the acquiring corporation and therefore the acquisition does not qualify for tax-free treatment. For this reason, taxpayers in a (B) type acquisition should make certain that the parent corporation, which issued its stock, holds the newly acquired stock for a fairly lengthy period of time. Additionally, they should be prepared to show that any later transfer of the acquired stock is a transaction completely independent of the original tax-free acquisition.

Treatment of Stockholders of Acquired Corporation:

Stock of Acquiring Corporation Received Tax-Free: The most obvious and immediate advantage of a nontaxable exchange to a seller is that he is thereby enabled to postpone recognizing taxable gain while changing the form of his investment.

In the case of an (A) or (B) type reorganization, the stock or securities of the acquiring corporation are received directly by the shareholders of the acquired corporation. As noted above, they recognize neither gain nor loss on receipt of the new stock or of securities, provided in the latter case that an equal face value of securities is given up. The same rule of nonrecognition of gain or loss by the stockholders also applies in the case of a (C) type reorganization, in which the corporation, substantially all of whose assets are acquired, ends up holding voting stock of the acquiring corporation. The Internal Revenue Code provides that this voting stock may be distributed by the corporation to its stockholders with no gain or loss on the transaction being recognized to the distributing corporation or its stockholders, provided that the distribution and the original exchange of stock for assets are part of a unified plan of liquidation. If property other than such voting stock is distributed the rules pertaining to distributions of "boot" (see page 108) are applicable.

Basis and Holding Period: Where only stock or securities are received in a nontaxable exchange, their basis is the same as the basis of the property exchanged. The holding period of the new stock or securities (for the purpose of determining whether they have been held for more than six months so that their sale would result in long-term capital gain or loss) includes the period the stock or securities given up in the exchange were held.

Effect of "Boot" on Tax-Free Acquisitions: "Boot" generally refers to cash or property received by stockholders of a selling or merging corporation other than stock or securities permitted to be received without the recognition of gain. "Boot" is taken into account at its fair market value. Obligations of the acquiring corporation received in excess of the principal amount of securities surrendered are also "boot," and are similarly valued at the fair market value of the excess.

An "A" or "C" type of reorganization can involve the payment of "boot" to the shareholders of the acquired corporation as well as the stock or securities permitted to be received without the recognition of gain. If the over-all exchange results in a gain, the gain is taxed to the extent of the "boot." Such gain is generally treated by the Treasury as a dividend to the extent of available earnings of the old corporation accumulated since February 28, 1913. Any excess taxable gain is capital gain. No loss is recognized.

To avoid this ordinary income tax on its shareholders, the transferor corporation in a "C" type reorganization will ordinarily transfer all its assets (except those needed to pay dissenting stockholders or other claims) to the acquiring corporation, even though such assets may include some that are not needed or represent excess working capital.

Where "boot" is distributed to shareholders or security holders, the basis of their new stock or securities is equal to the basis of the stock or securities surrendered, decreased by any amount of "boot" received which was not taxed. If all the "boot" is taxed, in effect no adjustment of basis is required. The holding period of the new stock or securities includes the holding period of the old, whether or not "boot" is involved in the exchange.

Treatment of Acquiring Corporation:

Basis and Holding Period: The tax basis of the assets acquired in one of the above tax-free reorganizations remains the same in the hands of the acquiring corporation as it was in the hands of the acquired corporation. The acquired corporation's holding period of the assets is "tacked on" to the time the assets are held by the acquiring corporation. In a situation where the acquired assets have a basis greater than the value of the consideration given for them, this carryover of basis can be advantageous, since it will increase the acquirer's depreciation deduction. The "tack on" of the holding period is also normally advantageous.

Carryover of Attributes: When a nontaxable form of acquisition is used, there are a number of tax attributes of the predecessor corporation to which the acquiring corporation succeeds. Sometimes these attributes may be desirable; in other situations they may be quite undesirable. Section 381(c) lists 21 such attributes which are carried over. While some of these attributes, particularly those relating to accounting, depreciation and inventory methods to be followed, can be quite important in individual instances, the attribute to which the most attention is usually devoted in planning corporation acquisitions is the net operating loss carryover.

The Net Operating Loss Carryover: The net operating loss carryover is available to an acquiring corporation in a combining reorganization only in the following cases: (a) When a parent company completely liquidates its subsidiary and acquires its assets as provided in Sec. 332, but only if the parent is not entitled to a new basis provided by Sec. 334(b)(2) for the assets acquired as a result of a purchase within two years prior to the liquidation. (b) In an (A) type reorganization. (c) In a (C) type reorganization.

The Internal Revenue Code contains limitations on net operating loss carryovers specifically designed to prevent the acquisition of "incorporated losses" as a tax avoidance device. If the stockholders of the loss corporation do not own at least 20 per cent in value of the stock of the successor corporation immediately after the reorganization as a result of owning stock immediately before the reorganization, the net operating loss carryover is scaled down. For each percentage point of ownership less than such 20 per cent, the net operating loss carryover is reduced by 5 per cent.

In addition, if the acquisition occurs during a taxable year of the acquiring corporation, the amount of net operating loss carryovers of the acquired corporation which may be deducted in that year is restricted under section 381(c)(1).

Section 269 also applies to tax-free acquisitions. This is the general provision which denies the benefit of any deductions, credits, or allowances (including the net operating loss deduction) in the case of acquisitions of control of a corporation or assets with a transferor's basis if the principal purpose of the acquisition was evasion or avoidance of federal income tax. This provision is discussed in greater detail in the section on taxable acquisitions.

(ii) Taxable Acquisitions:

From the standpoint of the purchaser, taxable acquisitions generally assume one of two forms: (1) acquisition of the stock of the company to be acquired; or, (2) acquisition of assets. Where sufficient stock is acquired, the purchaser may either liquidate the corporation or allow it to remain alive. The tax results to a corporate purchaser of at least 80 per cent of the stock (other than nonvoting preferred) depend upon whether the plan of liquidation is adopted within two years of the purchase. If it is, the cost of the stock is allocated to the assets acquired in the liquidation, with certain adjustments. If the acquired corporation remains alive, it retains its existing tax basis and methods. If the parent owns at least 80 per cent of its stock (other than nonvoting preferred) the acquired corporation can be liquidated tax-free into the parent. If no such action is taken until after the two years have elapsed, the acquired company's tax basis for the property carries over to the parent.

From the standpoint of the seller, sale of stock is the simplest method and results in capital gain or loss, providing, in the case of gain, that the corporation is not "collapsible" under section 341. Where assets are sold, there are various methods available of liquidating the corporation before or after the sale. Choice of the method, if any, to be followed will generally depend upon which produces the best tax results.

Purchaser's Tax Considerations:

Allocation of Purchase Price to Assets Acquired: Where the purchaser either acquires an entire business for a lump-sum consideration or acquires the stock of a corporation and liquidates it within two years, it becomes necessary for tax purposes to allocate the purchase price to the various assets acquired in order to determine their basis for depreciation, amortization and gain or loss on sale or other disposition.

Such allocation is required to be made on the basis of the respective fair market values of the various assets. In general, it is in the purchaser's interest to be able to show as high a value as possible for inventories of merchandise and supplies (which will be sold or consumed in operations within a relatively short period and thus reduce gross income from sales) or fixed assets (for which deductions for depreciation or amortization will be allowable). The purchaser will ordinarily wish to minimize the values assigned to land which he expects to retain indefinitely (no depreciation allowable), and especially values assigned to good will (which cannot be depreciated or amortized and can generally be deducted only upon sale or termination of the entire business). There is usually little dispute over the values of the other assets.

Usually, in the case of acquisitions of substantial size, appraisals by outside experts are made in order to substantiate the taxpayer's allocation of values.

In some cases, purchase agreements for assets break down the total consideration into separate amounts for various classes of property. Such break-downs are often helpful in securing an allocation which the purchaser desires, but are not binding on the Treasury if it can be shown that the entire agreement "hangs or falls together."

Noncompetition Agreements: The purchaser should not overlook the possibility of assigning some of the total price he is to pay to agreements with the principals of the selling corporation not to compete after the sale. Amounts paid for *bona fide* obligations not to compete are ordinary deductions, spread over the period of the agreement. The taxpayer must be prepared to prove to the Treasury that the noncompetition agreements were separately bar-

gained for by the parties and that they are realistic. Amounts received under noncompetition agreements are ordinary income to the recipients when received (assuming they report on the cash basis for tax purposes).

Prompt Liquidation of Acquired Corporation: Where at least 80 per cent of the stock of a corporation (other than nonvoting preferred) is acquired for more than the tax basis of the related assets, it is generally advantageous to liquidate the corporation and obtain a stepped-up tax basis for its assets under section 334(b)(2). In order to have the cost of the stock used as the measure of the tax basis of the assets, it is necessary that the plan of liquidation be adopted within two years of the purchase of the stock. The liquidation should generally, however, be accomplished as soon as possible following purchase, for otherwise, under the regulations, some of the increased basis for depreciable assets will be irretrievably lost.

Avoidance of Transferee Liability: Where stock of a corporation is purchased, the new owners acquire its assets subject to its liabilities, known and unknown, including liability for additional federal income taxes which may be assessed for past years. For this reason, there is a natural preference on the part of purchasers to acquire assets. Agreements of the seller of stock to hold the purchaser harmless from contingent liabilities are not binding on the Treasury. Therefore, where stock is acquired, it is a frequent practice to have part of the purchase price paid into escrow, to be released only after a long enough period has elapsed so that the principal contingencies are resolved.

Possible Unavailability of Loss Carryovers of Corporation Whose Stock Is Acquired: Under general principles, if stock of a corporation is acquired and the corporation remains alive, it carries on as a taxable entity under the new owners just as before. However, there are two specific provisions in the Internal Revenue Code which modify this principle.

First, if the principal purpose of the acquisition of control of a corporation was to avoid tax by securing the benefit of any deduction, credit, or other allowance, section 269 provides for the disallowance of the deduction, etc. This provision is most frequently applied to disallow net operating loss carryovers, but is applicable

to any deduction. It applies even where the acquired corporation is the one which takes the deduction. "Control" for this purpose means the ownership of at least 50 per cent of either the voting power or the total value of all the stock.

Second, if purchase of at least 50 per cent in value of the stock of a corporation (other than nonvoting preferred) is followed by a change in the business conducted, occurring before the end of the corporation's taxable year following the one in which the purchase occurred, section 382(a) disallows net operating loss carryovers, regardless of the purpose of the purchase.

Seller's Tax Considerations:

Sale of Stock: Where the sellers sell all their stock in a corporation, their tax situation is relatively simple. They receive capital gain or loss, provided, in the case of gain, that the corporation is not collapsible. Collapsible corporations, under the highly technical provisions of section 341, are those formed or availed of with a view to their liquidation, or a distribution treated as capital gain to shareholders, or sale of their stock before realization of a substantial part of the income from their property. Examples are corporations which construct apartment houses or produce motion pictures and then are liquidated or are sold at a profit before engaging in actual operations to any material extent. Gain on sale or redemption of stock in a collapsible corporation is ordinary income. Space does not permit a detailed discussion of the complex provisions of section 341.

Sale of Assets by Continuing Corporation: Where a corporation sells part of its assets, but remains in business, gain or loss is recognized on the sale. The gain or loss is capital or noncapital depending upon the nature of the assets sold. The effect of section 1231 is generally to make sales of land, buildings, machinery, equipment, and patents result in capital gain or ordinary loss. Inventory and accounts receivable result in ordinary income or loss, while investments and good will yield capital gain or loss.

If the selling price is less than tax basis, the sale may create a loss which can be carried back for tax refunds. To protect this loss, the corporation must not adopt a plan of liquidation before the sale takes place. Generally, it is desirable to keep the corpora-

tion alive for at least a year after the sale takes place, in order to avoid section 337 (discussed below).

If the sale results in a gain the corporation will be taxed if no steps are taken to avoid it. The alternatives to avoid such tax are discussed below.

Sometimes a corporation sells its operating assets at a gain but is deliberately kept in existence in order to avoid the capital gain tax the shareholders would have to pay on its liquidation. This course may prove advantageous where the major stockholders are elderly (the basis of their stock will be stepped up at their death) and where the corporate tax on the gain is relatively small or is payable over an extended period because the installment basis is being used. Such a corporation is likely to be a personal holding company under the Internal Revenue Code and, if it is, will have to distribute all its ordinary income in order to avoid the stiff penalty tax on accumulated income of such companies.

Sales of Assets by Corporation in Liquidation: A corporate tax on gain on the sale of assets can be avoided by using a "twelve-month liquidation" under IRC Section 337. This section provides that no gain or loss will be recognized to the corporation on sales or exchanges in connection with liquidations of qualifying corporations. The seller can comply with the provisions of this section by adopting a plan of liquidation before any sales are made and, within the 12-month period beginning on the date of adoption of such plan, distributing in complete liquidation all of the assets of the corporation, except assets retained to meet claims. Particular attention should be paid to the provisos of this section which exclude from nonrecognition gain or loss on sale or exchange of installment obligations and inventory, except where substantially all the inventory is sold to one person in one transaction. Although certain installment obligations qualify for nonrecognition of gain on the corporate level when they are distributed to the shareholders, the right to use the installment method does not carry over to the shareholder-recipients. These obligations must be taken into account at fair market value on the date of liquidation.

This section is not applicable to transactions involving a collapsible corporation. In transactions involving such corporation

(see IRC Sec. 341), any gain at the corporate level will be recognized as well as the gain to the stockholders on liquidation.

Sale of Assets by Shareholders Following Corporate Liquidation —Section 333 Election Made:

Section 333 provides for limited nonrecognition of gain on the complete liquidation of a corporation within one calendar month. Where a corporation is liquidated under this provision, the property received has a tax basis equal to the basis of the stock, increased by any gain recognized, and reduced by any money received. The shareholders are then in a position to sell the property received with only a single tax, at the shareholder level.

Section 333 applies only to those shareholders who elect its application. Shareholders are divided into two groups—corporate and noncorporate. The election does not apply to any shareholder unless 80 per cent or more of the voting power possessed by his group makes the appropriate election. A corporation owning 50 per cent or more of the voting power is excluded from the benefits of the section, but its stockholdings are not counted as part of the stockholdings of the corporate group.

In a section 333 liquidation, gain is taxed to a noncorporate shareholder as a dividend to the extent of the earnings and profits of the liquidated corporation accumulated after February 28, 1913. Any further gain is taxable as capital gain to the extent that the distribution consists of money or of securities acquired by the liquidating corporation after 1953. Under similar rules, a corporate shareholder's gain is taxable as capital gain. Excess gains are tax-free.

Section 333 does not apply if the liquidating corporation is collapsible under section 341.

Section 333 is relatively little used. If a substantial part of the distribution an individual shareholder receives is taxable as a dividend (ordinary income), he may be worse off by electing section 333 than if the entire distribution gives rise to capital gain under the general rule. Since, in a manufacturing or distributing corporation, retained earnings are apt to be substantial or difficult of precise determination, a section 333 liquidation is not generally

attractive. It is used, however, where corporate assets such as real estate have high appreciation and there are relatively small accumulated earnings.

Sale of Assets by Shareholders Following Corporate Liquidation —No Election Made:

An ordinary corporate liquidation with no section 333 election results in capital gain or loss for the shareholders, and the assets received have a tax basis equal to their fair market value. An immediate sale by the shareholders should then result in no gain or loss, for the amount received would equal the basis.

Such a liquidation followed by a sale is carefully scrutinized by the Treasury, which may contend that the corporation made the sale rather than the stockholders. If the Treasury is successful in upholding such a contention, the corporation would be taxed on the gain on the sale, and the shareholders taxed further on that gain, if any, on the liquidation. To avoid this risk, it is generally advisable for the corporation to qualify for nonrecognition of gain under section 337. This section, discussed above, requires adoption of a corporate resolution to liquidate before the sale and distribution of substantially all the corporation's assets within one year from the time the plan of liquidation is adopted.

Sale of Assets by Electing Small Business Corporation (Subchapter S):

An electing small business corporation may generally sell its assets without incurring tax, since under Subchapter S the shareholders, and not the corporation, are taxed on corporate earnings, whether distributed or not. Therefore, it may be immaterial whether or not such a corporation is liquidated when its assets are to be sold. A detailed discussion of Subchapter S is outside the scope of this book.

Sale of Assets Owned by Subsidiary Corporation: Where the business to be sold is owned by a subsidiary corporation and represents substantially all the assets of that corporation, it is immaterial whether the subsidiary sells the assets and then liquidates into the parent, or the subsidiary is liquidated first and the parent sells the assets. In either case, there is only one tax, since the liquidation of

the subsidiary into the parent is tax-free and the parent's basis for the assets is the same as the subsidiary's. The installment basis of reporting income is also available in either case. For this purpose, a "subsidiary" is a corporation where at least 80 per cent of the voting stock and at least 80 per cent of the number of shares of all other classes of stock (except nonvoting preferred) are held by the parent corporation.

Ordinarily, sale of a subsidiary's assets is preferable to a sale of its stock by the parent because the tax basis of the assets is likely to be higher than that of the stock (and the resulting gain smaller) as a result of the retention of earnings by the subsidiary. If, however, the tax basis of the stock is higher, the parent should consider a sale of the stock provided that it could use the resulting capital loss, if any, and would not gain any other advantages (e.g., operating loss carryovers) by liquidating the subsidiary.

Installment Basis of Reporting Gain: Upon any sale of real property or any sale of personal property for more than $1,000 outside the regular course of business, if the consideration is payable over a period of time the taxpayer may be able to elect to report the gain rateably as the proceeds of sale are received. This election is available only if the payments, if any, received in the year of sale do not exceed 30 per cent of the selling price. Obligations of the purchaser are not considered payments.

The installment method is not available to defer reporting taxable gain on liquidation of a corporation. Therefore, where use of the installment method is important to the shareholders of the selling corporation, it is essential that they sell their stock, leaving it up to the purchaser to liquidate the corporation under section 334(b)(2) if he wants a stepped-up basis for the corporation's assets.

Where the corporation sells assets, it may elect the installment basis of reporting gain if it meets the same tests as an individual. If the installment obligations are subsequently distributed to individual shareholders in liquidation, not only is the shareholder taxed on their value (except in a section 333 liquidation), but also the corporation is taxed at that time on the gain which has been deferred. However, if the gain on the sale of property is not recognized under section 337 because the sale occurred subsequent to

the adoption of the plan of liquidation, there is no tax to the corporation on the distribution in liquidation of installment obligations received on the sale.

The Accounting View

The accounting treatment adopted in combining the financial structures of two corporations has broader implications than simply technical accounting procedures. It can have a significant effect on the assets and capital structures of merged companies. For example, the amount of future depreciation and amortization will depend in part upon the particular accounting treatment used at the time of the combination. Because of these implications, this section describes the major accounting treatments of mergers and acquisitions. Examples of the statements resulting from each are given in Appendix B.

The accounting treatment of a business combination is determined by which one of two concepts is accorded to the combination and these are related to the business considerations motivating it.

> First, a corporation may combine the business of another with its own activities by acquiring the ownership interest in the other business. In this case the activities of both companies are carried on by the surviving interests and the former interests in the acquired business are eliminated or substantially altered. This is treated, for accounting purposes, as a purchase of one business by another.
>
> Second, the ownership interests in two or more businesses may decide to combine their businesses, efforts, and activities into a combined enterprise in which both groups retain their interests and which carries on businesses previously separately conducted. This type of transaction may be treated, for accounting purposes, as a "pooling of interests."

Effect of "Purchase" Accounting: The significant difference between a purchase and a pooling of interest is this. When a purchase occurs, and thus new interests are in possession of the business, a new basis of cost accountability arises for the assets acquired, predicated upon the value of consideration paid. Since the consideration is measured by current values, book values of the acquired com-

pany's assets are no longer relevant—although they may coincide with current values. Further, the purchase price of a business in many instances recognizes the existence of a goodwill or going concern value and thus represents an additional cost which must be accounted for.

The introduction of a new cost basis of accountability has a direct influence on future reported earnings of a business. Since the assets of a business are, in large part, subject to the depreciation or amortization which constitutes a charge against the income arising from their use, the introduction of a new cost results in future depreciation and amortization differing from the previous amounts upon which the historical earnings of the acquired businesses were based.

Thus, the earnings contribution to a company of an acquired business whose acquisition is accounted for as a "purchase" will, in most cases, differ from the previous earnings of that business because of the accounting, if for no other reason. While the consideration paid for a business based upon current values may be either more or less than the book value of the assets of that business, in the majority of instances it is greater than such book value, because of the effect of inflationary trends and the fact that the successful conduct of a business usually generates a goodwill factor for which the purchaser pays a consideration. There are, of course, cases in which the earnings and prospects of a business are such that the consideration which a buyer is willing to give, and a seller willing to take, is less than such book value but these are in the minority.

Effect of Pooling of Interest Accounting: A combination viewed as a pooling of interests does not call for a new basis of asset accountability as does one viewed as a purchase since it is deemed to represent a continuation of existing ownerships. Historical book values of the assets of the combining or constituent companies are carried into the combined enterprise as a basis for accountability (subject, of course, to such adjustments as may be called for to place differing accounting methods on a common basis). There is no need to recognize a goodwill factor since no change of ownership is deemed to have occurred and therefore no cost basis for accounting recognition of goodwill is created. The accounting relating to such a combination has no influence on combined earn-

ing power. Further, when businesses are combined and the combination is accounted for as a "pooling," the earned surpluses (or deficits) of constituent companies are—consistent with the concept of continuity—carried forward into the combined company.

At this point it may be helpful to make certain observations about the effect upon earnings of the form of accounting adopted for a combination of business activities. In the case of a purchase, when the value of securities issued for a business exceeds the book value of the assets of that business, a write-up of asset valuation occurs and future earnings are subject to larger charges for depreciation or amortization. Conversely, where the value of consideration issued is less than the book value of the net assets of the business acquired, such charges may be expected to be less in the future than they otherwise would have been.

Distinction Between "Pooling" and "Purchase" Accounting: This discussion of the diverse accounting effects of pooling or purchase accounting might not be so important if a particular transaction could be accounted for in only one way. In practice, however, many combinations have some attributes which indicate a pooling of interest while others suggest a purchase. Of course, if a business is acquired in consideration for the payment of cash (or its equivalent in bonds or notes), it is clear that there has been a purchase since the acquiring party owns all of the business assets, including goodwill, and the seller has no further interest, except possibly as a creditor. However where an exchange of stock is involved, there may be elements both of a purchase by the acquiring group and continuing interest by the selling group by reason of its resultant stock interest in the acquiring company. In these circumstances the choice of what is appropriate accounting becomes a matter for exercise of judgment, influenced by the intent of the parties and the form (as evidence of intent) which the transaction takes. The "form" of the transaction just mentioned does not refer to the legal form which the combination takes—merger, consolidation, acquisition or exchange of stock (which for these accounting purposes is not relevant)—but to certain factors which will next be discussed.

The American Institute of Certified Public Accountants issued a statement[1] concerning business combinations in which the

[1] Accounting Research Bulletin No. 48 dated January 1957 issued by Committee on Accounting Procedure now superseded by the Accounting Principles Board.

various factors entering into a distinction between a "pooling of interest" and a purchase were discussed. Basically, this bulletin describes a business combination which might be accounted for as a pooling of interest as being one in which the holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituents, either directly or through one or more subsidiaries. It then describes as a purchase that form of business combination in which, appositionally, an important part of ownership interests in one of the companies is eliminated. It further enumerates certain factors or criteria (discussed later) that would show which of these two natures a particular combination partook. The statement emphasizes that no one of these factors would necessarily be determinative, that any one might have varying degrees of significance in different cases and that in some instances different relevant factors might be in conflict. It states, however, that the presence or absence of factors indicative of a pooling of interest would be cumulative in effect and that a decision as to whether a combination was a purchase or a pooling of interest should be made in the light of all such attendant circumstances.

The A.I.C.P.A. statement, referred to above, discusses factors indicative of the presence or absence of a pooling of interest type of transaction under the general categories of continuity of ownership, continuity of business and management, and presence of certain size relationships. Because of the importance of having the form of a particular business combination partake of the characteristics which will lend to its being accounted for in accordance with the intention and desire of the parties, these factors will be discussed at some length. As was stated, purchase accounting is indicated in circumstances opposite of those indicative of accounting on a pooling of interest basis. The following discussion of factors will be from the standpoint of their appropriateness to pooling of interest accounting but, for the reason just stated, will at the same time serve as a discussion of factors which would evidence the appropriateness of purchase accounting.

One point should be noted. In order to account for a combination as a pooling of interests, requisite criteria must be met and if they are not the transaction must then be accounted for as a pur-

chase. However, even though these criteria are met, a combination may, if it is so desired, be accounted for as a purchase. In this sense the application of pooling accounting to a transaction is optional.

Continuity of Ownership. The bulletin states that, in a pooling of interests, stock to be received by the owners of constituents shall be proportionate to their interests in predecessor corporations, and that there shall be no substantial alteration of voting rights. This means that, in the usual case, it would be expected that holders of common stock of constituents would receive common stock of the combined company, holders of preferred stock would receive preferred stock, etc. so that there would be no substantial modification of rights represented by stock holdings in constituents. There have, however, been instances where valid business considerations indicate the desirability of the issuance of preferred stock to holders of common stock of a constituent and this has not been deemed to negate the concept of a pooling of interest. Where preferred stock is so issued, it should, desirably, possess voting rights and be convertible into common stock. It is obvious of course that the issuance of a substantial amount of non-voting preferred stock for voting common stock would result in an alteration of relative voting rights.

Consistent with the concept that a pooling of interests is essentially a continuation of existing ownership interests in different form, the bulletin states that, in a pooling, a plan or firm intention and understanding by the parties to retire or sell a substantial part of stock issued to one or more of the owners of a constituent would not be expected to be present. The reason for this statement seems evident—to the extent that such plan or intention would exist, a combination would partake of the nature of a cash acquisition. However, the fact that certain parties may dispose of some of the securities which they receive in a business combination—or may even receive cash directly in part consideration of their interests—does not necessarily nullify the concept of a pooling of interest provided that such disposition or receipt of cash are clearly motivated by collateral considerations, even though the amounts involved may be fairly substantial. For example, the retirement of inactive stockholder interests which, even in the absence of a combination, would have probably been retired, would

not necessarily bar a combination from being accounted for as a pooling. Nor would disposal by a stockholder of a portion of securities received by him in order to achieve reasonable personal investment diversification have this effect. Further, it is conceivable that funds above amounts needed in the business might be distributed to shareholders coincidentally with a combination but not necessarily as a direct result of such combination.

Continuity of Business and of Management. These criteria, while separate, are to a large extent related. The A.I.C.P.A. bulletin states that abandonment or sale of a large part of the business of one or more of the constituents to a business combination militates against considering it as a pooling of interests. It seems apparent that the acquisition of only certain assets of a business or a limited part of its operations does not, from a reasonable business and economic viewpoint, represent a combination of businesses. On the other hand, the disposition by a constituent of an unprofitable line or of a line of business which would not fit into a complementary character of operations of the combined business would not necessarily militate against the combination being considered, for accounting purposes, as a pooling.

Similarly, continuity of management, as a criterion indicative of a pooling, is suggested as being a condition which might be expected to accompany continuity of ownership. It is to be expected that management continuity to a substantial degree will accompany a combination which appropriately is to be accounted for as a pooling of interest.

In discussing continuity of management, the bulletin refers to the fact that if influence of the management of one of the constituents upon the over-all management of the enterprise is very small, a purchase (rather than a pooling) may be indicated. The requirement for participation in over-all management has in practice been construed as being met where the management of a constituent continues in management control of that segment of combined activities that were previously separately conducted by that constituent. The requirement has not been generally viewed as necessitating, in all cases, representation on the board of directors or among general corporate officers—the latter requirements would obviously not be feasible in the case of many combinations

because of the attendant cumbersome size of the directorate and official group.

Relative Size. The A.I.C.P.A. bulletin recognizes that relative size is a factor in determining the substantive effect of a combination but one that is not necessarily determinative. It states, however, that where stockholders of one of the constituent companies represent 90% to 95% or more of the voting interest of the combined enterprise there is a presumption that the transaction is a purchase rather than a pooling of interests. In practice several business combinations have been accounted for as poolings of interest even though one of the parties represented less than the 5% minimum indicated in the A.I.C.P.A. bulletin. While relative size must be considered as a factor, it is one that is difficult to evaluate and, unless the concept were to have been limited to combinations of approximately equal size, the imposition of a minimum becomes somewhat arbitrary. For example, in some cases a combination may be only part of a series of combinations effected under a single plan and in these circumstances the relative size of any one is unimportant.

Chapter XI

Negotiation

When representatives of two companies sit down at the bargaining table, it is often deceptively simple to settle prices and conditions in general terms. The specific details are likely to prove more troublesome, and bargaining skill in the resolution of these issues can solve many problems which might arise later to plague the combined operation.

The objectives of negotiation are to obtain information, to explore topics of mutual interest, to head off assimilation problems, and to set a price or exchange ratio. In general, skill in negotiation depends heavily on the team's background briefing and its appreciation of negotiation problems.

Obtaining information goes on throughout the merger and acquisition process, even into the negotiation stage in many cases. Companies that are not certain they wish to be acquired may refuse to provide detailed information on their sales and finances until negotiations are actually under way. Even companies for which figures are available have information on a wealth of other topics which may not be revealed until negotiations begin. This information must be assimilated into the acquiring company's plans, and final evaluation may not be possible until several bargaining sessions have been completed.

The mutual exploration activity is a combination of informa-

tion gathering, future planning, and feeling out the opposite side for bargaining strengths and weaknesses.

As discussed in Chapter XII, assimilation problems should be taken up in detail before, rather than after, an acquisition is consummated. Here again, information gathering is of the essence.

Allocation of Profits

Setting a price or exchange ratio has been discussed in the evaluation section. Certain aspects of it, however, must be worked out at the bargaining table. One major point is the question of the allocation of the profits resulting from any advantages the merged corporation may have. Most people, in undertaking a merger or acquisition, do so on the assumption that one plus one will equal three or, at least, two and one-half. In actual experience, this frequently does not prove to be the case. Nevertheless, the common assumption at this stage in negotiations is that the two companies will be more successful combined than separate. Each will attempt to obtain a maximum share of the expected improvement in earnings capitalized. The situation is further complicated by the fact that neither corporation, particularly the acquiring one, is likely to reveal precisely what it thinks the magnitude of the improvement may be. The end allocation depends upon the bargaining strengths of the two companies. Thus, if the acquiring company is purchasing another in order to obtain increased production facilities without the expenditure of time necessary to build them, the whole of the estimated earnings increase is likely to go to the acquiring corporation. In contrast, however, if the acquiring corporation is attempting to obtain skillful management because of weaknesses in its own executive staff, the uniqueness of the benefits sought is likely to result in the acquired corporation obtaining for itself a substantial amount of the anticipated earnings increase.

One of the common problems in bargaining on profit contribution lies in the dilution of near-term earnings for an acquiring company in its efforts to make a substantial earnings contribution in the later years. If Buyer Company has a demonstrable basis for being enthusiastic about the opportunities for the combined companies, it need not give any expression of such enthusiasm beyond a reasonable amount of confidence to overcome Seller Company's

reluctance to sell out a business with its loyal employees, etc. The situation which can arise in bargaining might look like this.

Company B is acquiring Company S for 50,000 shares of B's common (there are 250,000 outstanding and 500,000 shares authorized before acquisition of Company S). During the year of the transaction (both companies are close to the end of their fiscal year) B estimates its earnings per share at $7.20 without adjustment for acquisition of S. Company S gives every indication of earning $250,000 or $5.00 on the 50,000 shares which are tentatively agreed they would receive. B, when combined with S, would dilute B per share earnings or put another way, S would have a greater total earnings in the combined company than it had in S. B's management, however, is aware of considerable anticipated plusses which will come from the union through use of common marketing organization, savings in raw material purchases which it can now buy from a department of S which had not been selling to B, but of greatest importance is that B has an opportunity to exploit a reserve deposit of S's natural resource to which S had attached little value. B's negotiating team settled favorably to B for 50,000 shares, but only by pointing out the earnings dilution of its stockholders. The appreciable benefits to B's shareholders would come in the near future and within two years would add over $2.00 per share to the original $7.20 per share. S might well have driven a harder bargain had it been fully aware of the total benefits. In any event, S shareholders participated to an extent by taking shares in Company B.

Apart from a variety of interesting problems in sorting out contributions to the future of combining companies there are others involved in the selection of media of exchange and the timing of the payment. These are discussed in the next sections.

Method of Payment

Straight cash or common stock are the usual media of exchange in acquisition or merger, but combinations using some of each or coupled with a form of preferred or senior securities may fit the needs of particular circumstances. Each situation will generally have conditions which can best be settled by considering the special needs.

Where simple conversion of equities will give the seller's shareholders a more secure portfolio, or a negotiable stock as in the case of a privately held company merging with a publicly held concern, or where the sellers are anxious to defer taxes on gain, the traditional voting common and the "tax-free" merger may be the answer. If the seller's shareholders have been accustomed to a higher dividend payout than the acquirer has been declaring on its common stock, then a security with prior payments of dividends or interest may be useful. In addition, some deals are made to supply the seller with convertible preferred to give greater assurance of income but with a right to convert into common at the seller's option at the time he wishes to move into an opportunity for equity appreciation.

Where the buyer is anxious to prevent dilution of control or asset value of common shares, or where the current market value of buyer's common is low in comparison to market values for similar companies, the seller may agree to debentures, preferred, or cash. Some "sweetener" may be needed to offset the lower common value or to satisfy needs for cash to pay taxes. Minority shareholders of the seller may require cash payment instead of taking common. This is particularly so where the minority holders are not satisfied with exchange rates set for common or with the entire program of combination. Some dissident stockholders of the seller may be satisfied with a special preferred to suit their conditions.

Special conditions arise where the seller's asset values can be exchanged for cash or debentures with goodwill exchanged for common. Seller then receives payment for his fixed and liquid assets, but takes the risk on the future earnings and appreciation of the excess total price which he has negotiated.

During recent periods when the stock market has placed high earnings multipliers on growth industries, i.e., electronics, pharmaceuticals, food processing, common stock has been an attractive medium of exchange. Some acquisitions have looked excellent from the seller's side when the total market value received has been calculated, but as the recent market decline has reduced the multipliers the values have changed appreciably. Such radical changes have caused cash deals to seem more attractive. Common stock has been a difficult medium for some acquisitive companies

whose fortunes have suffered in recent years but who have wished to diversify into growth areas. In those cases, asset values have been high in comparison to market value of stock and cash has been the more useful medium. Attractive stock opportunities for stockholders of the acquired company exist, however, where the acquisition or merger can provide the growth impetus to cause the market to capitalize the new entity at higher multipliers.

Timing of Payment

A point of considerable importance that is often overlooked in negotiations concerning price or exchange ratio is the question of timing, yet proper timing of payment is a means of solving many of the problems inherent in setting a price. Most pricing problems are related to the uncertainty of future performance of the acquired company or the combined companies, since projections of sales and earnings, however carefully performed, are only informed estimates. By using a payout scheme, one can frequently avoid some of these uncertainties and, at the same time, provide both parties with a fair participation in the performance of the combined company.

Deferred Payment

Under a deferred payment arrangement a fixed amount of money or stock is paid by the acquiring corporation at the time of the acquisition. Thereafter, further payments are made over several years, depending upon the actual results produced during the period. The usefulness of such an arrangement lies in the fact that the owners of the selling company are assured of receiving a minimum price and yet are enabled to participate in the future performance of the company they have built. This is of some importance where a growth company is being sought. By the same token, the acquiring company can thus be assured that if the acquired firm fails to live up to expectations, the total price will not exceed the minimum. It seems very likely that this useful arrangement will be more and more prominent in future acquisition negotiations, but confined principally to those cases in which the acquired operation can be sufficiently separated as to allow for reasonable measurement of continuing performance.

The method is a means of bridging the gap of valuation between

an amount which the buyer believes is an amount it is willing to commit firmly and the higher amount which seller feels his company is worth. The difference can be set as the contingent payment which buyer is willing to pay if the seller can actually justify it by future earnings produced.

If the company is acquired and a deferred payment plan is adopted which is simply a use of installment purchase, i.e., to cut down initial cash expenditure, there is no problem of maintaining separation of operation. Where the deferred payments are related to earnings produced, the issues to be faced in the future are those of accounting for the earnings so as to provide an equitable base for payment calculation. If S is to be absorbed into B's operations by combining marketing functions or manufacturing, or if B's management decides to change the product course of S after a year or two of combination, problems of identifying earnings contribution for applying payout can be severe. The fairly autonomous subsidiary or division remaining substantially in the control and direction of S appears to be a requirement for applying contingent payout. Some interesting techniques for deferred payment are worth reviewing here.

Company X, a large, diverse holding company, has acquired a number of operating companies and, in most cases, has arranged for a cash or stock "down payment" but has used both simple and highly sophisticated payout schemes. One acquisition called for an initial cash payment equal to the value of net current assets plus an appraised fair market value of depreciable and other fixed assets with an arrangement to pay to the sellers 25% of each year's pretax earnings for a period of ten years with no ceiling on the maximum amount to be paid. This method gave seller considerable incentive to produce in the future and offered a means of meeting his optimism for his company's ability to generate substantial earnings which buyer was not willing to accept beforehand.

In another deal, Company X used a method of common stock payment of 20% (40,000 shares) of a total evaluation as a down payment with 80% (160,000 shares) of the total number of shares to be determined on the basis of earnings generated on the following formula:

Eight payment periods to be defined as:

(1) Company X 1960 fiscal year
(2) The two-year period from commencement of 1960 through 1961
(3) Six three-year periods commencing with 1960 fiscal year through 1962, moving one year forward each period.

The amount of stock to be paid in each of the earnings periods will be determined as follows:

1960 Earnings Period: Divide an amount equal to 7½ times Seller's pretax earnings for the 1960 earnings period less an amount equal to the cumulative market value of 40,000 shares by the average Company X share value for 1960.

1961 Earnings Period: Divide an amount equal to 7½ times Seller's average pretax earnings for the earnings period, less an amount equal to the cumulative market value of all Company X shares delivered prior to this earnings period by average Company X share value for the last fiscal year of such period (in no event shall the total shares delivered through the 1961 earnings period be greater than 100,000 shares).

For all subsequent earnings periods divide an amount equal to 7½ times Seller's average pretax earnings for the earnings period, less an amount equal to the cumulative market value of all Company X shares delivered prior to this earnings period by the average Company X share value for the last fiscal year of such period.

In any event, all obligation for continued deliverance of Company X shares shall terminate and all of Company X's obligations shall cease on the occurrence of either of the two following events:

(1) Upon the deliverance by Company X of 200,000 of its shares, or
(2) Upon the deliverance by Company X of shares with cumulative market value equal to $3 million.

The cumulative market value shall be the average value at time of delivery of all shares and shall be determined as follows:

The price on the last day of each month shall be averaged to determine the price of the Company X stock for use in the above formula.

If the Company X stock is listed on an exchange, and if listed on more than one exchange, the price shall be that of the stock on the major New York exchange with which the stock is listed. If the stock is not listed on a major exchange, then the average between the bid and asked price on the last day of each month shall be averaged to determine the cumulative market value of such stock.

Provisions were set forth in the purchase and sale agreement to provide for separate accounting in order to determine the earnings of the "Division" as an autonomous company.

It was also provided that adjustments would be made in the amount of shares to be paid and the adjustments that would be made if the Company X stock were split, if stock dividends were paid, if merger were accomplished and other similar factors that might affect the value of Company X stock as compared to the stock at the time the agreement was made. The usual provision for management charges and so forth, which have been an element of all Company X acquisition procedures, were also included.

The significance of this agreement for deferred payment is that the periods used to determine earnings are on a three-year basis, rather than being determined by any single year, so that over a period of any three years a loss suffered by Seller would average itself against profits in other years of the period in order that Company X would not be subject to a year in which a large amount of stock would be delivered. This plan has become a standard plan with Company X and has been developed over the years from the straight deferred payment plan which it used at the commencement of its expansion program.

It is interesting to note that in one of Company X's earlier acquisitions (and one of its largest) it became desirable, some four years later, to expand the division substantially by adding an entirely new product line to its production. This was a cash rather than a stock transaction and Company X and the sellers mutually agreed to terminate the arrangement with a rather substantial payment by Company X to complete the payment. A ruling was obtained from the Treasury Department that the fact that the parties had mutually agreed to terminate the remaining payments by the payment of a fixed amount did not in any way change the

tax implications that had existed prior to the agreement. While the amount to be paid was a definite sum, the money was to be paid over a period of time. To make the capital gains tax applicable at the time the money was received, rather than when the fixed amount was agreed upon, it was important that no evidence of indebtedness such as a negotiable note was given to the sellers and it was also important that no security was put up to secure the amount due to the sellers.

Thus, price negotiations involve not only the amount of payment, but the method of payment (i.e., in cash, in stock, or in some combination), and the timing of payment (on transfer, on a future schedule and in fixed amounts, or on a future schedule but on an earnings basis).

Negotiation is generally regarded as a highly individual art, and there is no question that skill at negotiation is a rare and valuable attribute. Nevertheless, successful negotiations can be conducted objectively by employing methodical analysis of the problems and opportunities involved. This analysis requires the use of objective measurements. Throughout this book, there are suggested a series of analyses which give the negotiator the facts he is likely to need in order to strike a fair and advantageous bargain. Before beginning negotiation, the representatives should re-examine the criteria used from the beginning in making the selection. They should be thoroughly acquainted with any research results from studies undertaken in the course of the acquisition search and analysis, and they should consider once again why the prospect is desirable and what it is worth to the acquiring company.

It is highly useful for the negotiating team to determine in advance what matters are negotiable and what are not. These decisions can be made on the basis of the objectives and criteria. Presumably, matters relating to the high-priority criteria cannot be negotiated without the acquisition itself becoming useless. For example, if a company seeks to acquire another primarily to obtain one of its product lines or some of its management, it will be unwilling to consider any arrangement that does not obtain for it the attributes which are its very reason for purchasing. All matters not relating to the high-priority criteria presumably are subject to negotiation.

By its evaluation process, the acquiring company will have determined the maximum price it is willing to offer. It should also, if negotiations are to move forward smoothly, try to determine the minimum acceptable offer. The ultimate selling price should fall between the two.

A negotiating team is well advised to consider in advance the topics to be avoided. For example, if the acquiring company intends to move the plant of the acquired corporation or to dispense with some of the executives, there is no point in introducing the subject if it is likely to cause controversy. However, the acquiring company's negotiating team must plan in advance its response to introduction of such topics by the prospects. If certain key people are necessary to the probable success of an intended acquisition, there will be little gained by not discussing possible courses of action. Here again, the objectives in the acquisition will determine the approach taken to disclose plans.

The assimilation problems that must be settled should be listed, item by item, to assure that they are taken care of in detail before the merger is consummated. Since difficult problems may have to be settled with price adjustments, it is well for the negotiators to consider how much the satisfactory solution of a particular problem is worth in money.

Chapter XII

Assimilation

This section is relatively brief, not because it is unimportant but because many of the actions needed for assimilation have been described in earlier parts of this study, and some of the problems can be substantially reduced by thorough work prior to the consummation of the merger/acquisition. Nevertheless, some known problems will undoubtedly not be solved purposely, during the period of search, evaluation, and negotiation, and to these there will be added many unanticipated situations. Assimilation has no absolute beginning and end but closing a deal and getting into operating problems requires some legal and operating formalities.

Assuming a general agreement of the respective managements or owners, and depending on the form of fusion (i.e., stock exchange, cash purchase, etc.), stockholder tenders or agreements may be needed, and the operating managements informed. Appendix D is an agenda of formal action of two typical companies leading through the early legal requirements to the point where the respective managements can get to the operating problems. Appendix E carries a brief description of a timetable covering corporate problems of a financial and operating nature to carry an intended merger from the state at which the principal stockholder, holding about 20% of the common, has agreed to sell his shares through the tender offer, press announcements of offer, final completion of offer and announcements to and meeting with principal employees of both companies.

During the period of first realization that a deal has been made, organization shock waves may move through top management, particularly through that of the acquired group. Since Buyer in acquiring Seller has need to keep a solid core of S's management, it has taken action promptly to bore into the organizational, personnel, and policy clarification. Appendix F goes along with the timetable in Appendix E and carries the administrative check list which applied to that acquisition. This example is specially shown as it is the check list derived as a result of previous acquisitions. Matters of personnel get first consideration.

Once the acquisition has been consummated, each party is in a position to become much more intimately familiar with the other's operations. In particular, the acquiring company now has the right of access to all information of interest about the acquired company, some of which may have been withheld during the period of negotiation. Accordingly, the first action called for is a thorough review of all data accumulated to date and the gathering of additional information needed to complete the picture. Thus, the acquiring company will develop a thorough understanding of the resources and operations of the acquired firm and establish a sound basis for planning the future of the consolidated entity.

The first major problem to be resolved following an acquisition is the nature and extent of consolidation which is desirable. In some instances, it may be best for the acquired company to continue operating essentially as an independent organization, with only minimum direction and control from the acquiring company; it may be to the acquiring company's advantage to operate as a silent partner, particularly if it has only limited knowledge of the acquired company's field. In other instances, it may be advantageous to absorb fully the acquired company within a relatively short period of time; if the acquired company was obtained primarily for its product line and certain key individuals, integrating the individuals into the acquiring company's organization and liquidating its production facilities would be appropriate.

The problem of the extent of consolidation to be accomplished should be faced squarely during the evaluation and negotiation stages. The basic requirements governing decisions in this regard are maintaining the strengths of the individual parties to the merger and developing new strengths out of the merger. Ob-

viously, the extent and timing of consolidation should be based on rational and objective analysis.

It is extremely critical for the acquiring company to protect the value of its acquisition during the period of transition. Protecting the value of fixed assets is a relatively minor problem, but preserving the value of good will and future earnings expectations, especially if they are a significant function of the key individuals in the acquired firm, is a problem of much greater magnitude. It is especially important that the acquiring company act promptly to maintain the morale of personnel and to retain the services of those whose resignations would significantly reduce the value of the purchase. Accordingly, a general plan should be prepared as soon as possible which indicates how and where the acquisition and its people fit into the corporate structure. Operating policies should be formulated and clearly communicated to all of the pertinent people in the acquired company. Key personnel should be specifically instructed about their authority, responsibility, and reporting relationships.

Inequities in compensation levels have been a stumbling block in many mergers. Sometimes it is practical to reduce individuals' compensation, but this entails a risk of losing their services. When such risk is not tolerable, or when it is important to retain the services of an individual yet fit him into an existing corporate salary structure, a lump-sum settlement is useful. It is necessary to recognize that key individuals, even though they own no share of the business, have a vested interest in the company and in the positions which may have been built up over a period of years; for example, a man in his middle to late fifties who has been with the company for 20 years and has reached a high managerial position might reasonably have expected to finish out his working career with the company on essentially the same basis as pertained prior to the consummation of the merger. Opportunities to shift to a company in which he has no vested interest and yet maintain his level of compensation may be extremely limited or nonexistent. It is, therefore, reasonable to make a settlement which compensates for the planned salary reduction during the anticipated remaining period of the man's employment. Such a settlement should, of course, be tied to a long-term employment contract which provides sufficient incentive.

A second major problem area requiring prompt action is marketing. Relationships with independent distribution organizations may be of considerable importance to the continued success of the acquired firm. Such organizations should be promptly informed of the policies of the acquiring corporation and of any modifications anticipated in existing agreements. Possible misconceptions should be corrected if necessary; for example, a distributor may have gained the impression that the acquired company's product line is soon to be distributed through the acquiring company's sales organization.

If an acquired company sells directly to a relatively few customers, the acquiring company should make a special point of having one of its executives call on these accounts to explain the acquisition move and its effect, if any, on the customer. Such a call may, in fact, afford an opportunity for improving existent goodwill and laying the foundation for significantly increased business in the future. If an acquired company markets durable goods to consumers or broad industrial markets, a statement should be communicated to customers regarding continuance of and/or changes in guarantee and service policies. The acquiring company should, in addition, be particularly alert to adverse trade rumors (which are sometimes planted by competitors) and move quickly to combat them.

A third major short-term problem area is procedural matters such as accounting and control systems, work rules, grievance procedures, engineering drawing systems, shop practices, time standards, employee performance reviews, and supervisory reports. Existing methods can sometimes be continued even though they differ radically between the acquiring and the acquired companies. This is most likely to be feasible if the acquired company is to be operated as an essentially independent subsidiary or if its facilities are considerably distant from the acquiring company's plant.

Inevitably there will be some conflict in procedures on the acquisition. If a conflict exists, it is best to analyze the functions accomplished by existing procedures and then to consider the merit of entirely new ones which meet the requirements of both companies.

Once the acquisition has been consummated and the acquired company has been assimilated, the entire planning cycle begins again. The consolidated entity should be examined in the light of the objectives and plans established earlier in order that management may determine what has been accomplished and what still remains to be done. Unanticipated advantages (and disadvantages) of the acquisition should be evaluated. The combined resources of the new organization should be assessed, and an analysis should be made of the impact of the merger on the outside world in terms of the resulting new corporate image, the changed relationships with customers and suppliers, its position vis-a-vis competition.

It may be necessary or desirable for the company to modify its objectives in light of new opportunities and/or new restrictions on the company's freedom to act. A new or modified long-range plan should be worked out specifying how, when, and to what extent the combined resources should best be reorganized for maximum effectiveness. It may be desirable to continue the merger and acquisition program, but to redirect the emphasis on the basis of results to date and new opportunities which have been developed through the initial acquisition. It may have become desirable to make additional acquisitions which complement the first one, the means of exchange available may have been significantly modified, or the amount of effort devoted to the assimilation phase of the merger and acquisition program may need to be changed significantly.

APPENDICES

APPENDIX A

Statutory Law Relating to Acquisitions

General

Governmental requirements present numerous factors which must be considered when acquisition of a going business is being planned. A thorough knowledge of these governmental requirements should be obtained before an extensive study concerning a proposed acquisition is initiated. Knowledge of the steps and proceedings by which an acquisition can be legally effected not only helps with the mechanics of carrying out an acquisition but also is extremely important in the guiding selection of the particular form under which an acquisition can best be made. The laws and regulations illustrate (1) how an acquisition is legally effected, (2) the rights and obligations concerning corporate powers, franchises, privileges, property, liens, debts, liabilities, etc., flowing out of an acquisition, (3) the effect of an acquisition on corporate structure, (4) the basis upon which the ownership in the new or surviving organization shall be distributed, (5) the rights and liabilities of assenting stockholders, (6) the rights of dissenting stockholders, etc.

The main purpose of this bibliography, therefore, is to provide a brief review of the responsibilities of the various governmental agencies with respect to acquisitions and to cite the pertinent statutes and regulations which each agency administers. These

agencies are arranged alphabetically as follows:

Antitrust Division, Department of Justice
Civil Aeronautics Board
Comptroller of the Currency, Treasury Department
Federal Communications Commission
Federal Deposit Insurance Corporation
Federal Home Loan Bank Board
Federal Power Commission
Federal Reserve System
Federal Trade Commission
Internal Revenue Service
Interstate Commerce Commission
Securities and Exchange Commission

Many companies contemplating the acquisition of another company need only check (for federal clearance purposes) the Antitrust Division and the Securities and Exchange Commission requirements. Others, subject to more stringent regulation, i.e., banks, public utilities, etc., must check the requirements of several government agencies. For example, banks in the United States are subject to supervision by several authorities. The Federal Reserve supervises all member banks. The Comptroller of the Currency (Treasury Department) supervises all national banks. The Federal Deposit Insurance Corporation supervises all banks that have their deposits insured. Thus the same bank may be subject to the authority of as many as five governmental agencies.

The material for this appendix was drawn from the laws contained in the United States Code as amended by the laws enacted in 1960 and those contained in the Code of Federal Regulations (for federal statutes and regulations).

Administrative Responsibilities

Department of Justice: It is important that all companies considering the acquisition of another company, even though they may be subject to regulation by some other government agency, board, or commission, be alert to the requirements imposed by the Antitrust Division of the Department of Justice. The Antitrust Division can even attack an acquisition which has received prior approval of a governmental regulatory body.

The Antitrust Division of the Department of Justice has the responsibility for the enforcement of the antitrust laws in the Federal Courts. In the performance of its duties, the Division receives complaints and initiates investigations of violations with respect to many statutes. Therefore, a company considering the acquisition of another company and wishing to avoid antitrust action must be cognizant of the many avenues from which such antitrust action may approach. For example, when a company acquires a new business, antitrust problems may arise from prior violations by the acquired company of such legislation as the Robinson Patman Act. This act makes it unlawful for any person engaged in commerce to discriminate, either directly or indirectly, in price, services, or facilities between different purchasers of like commodities.

Of primary importance for consideration prior to the acquisition of a new business are the Sherman Act and the Clayton Act. Under the Sherman Act, the combination may be regarded as an unreasonable restraint of trade, while under the Clayton Act, such acquisition may be illegal through violation of Section 7 of the Act.

For businessmen in the vast majority of industries the provision of the antitrust laws that is of paramount importance in a merger/acquisition program is Section 7 of the Clayton Act, sometimes referred to as the "Antimerger Law". Congress made it plain in the legislative history of this Act that its purpose was not solely to prevent mergers that would result immediately in monopoly power. The purpose of the Act is much broader. Section 7 states in part:

> "That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

Thus, in evaluating the likelihood of action on the part of the Federal Trade Commission or the antitrust Division of the Justice Department, either of which can institute proceedings under

Section 7, it is necessary to consider the sorts of situations that are regarded by these enforcement agencies and the Courts as tending to "lessen competition in any line of commerce in any section of the country."

The legislative history of this section indicates that Congress intended that all three major types of mergers/acquisitions would be covered by the Act. They are:

1. The horizontal merger—those between companies selling goods or services to the same types of customers for the same end uses. The companies need not have been in actual competition. Thus, the merger of two regional manufacturers of the same item located in different regions would be a horizontal merger though it might not violate Section 7.

2. Vertical mergers—those combining two different levels in the chain from extraction of raw materials through production levels and marketing to the ultimate consumer. Such a merger is described as "backward" if the acquiring company obtains one of its suppliers or potential suppliers and "forward" if it obtains one of its customers or potential customers.

3. Conglomerate mergers—those mergers in which there is no relation between the acquired company and the acquiring company. In short, the typical diversification acquisition of a company falls under the definition of conglomerate merger. As a practical matter, however, there has been very little effort to prevent conglomerate mergers. The only such action brought in the history of the Clayton Act would seem to indicate that unless both the acquired and acquiring companies are giants in their fields and possess some common characteristic that gives them an unusual combined strength, such as selling through the same distribution channels, the enforcement agencies are not likely to disturb conglomerate mergers.

There are two other factors that are not widely comprehended and that can be dismissed from further consideration. These are:

1. The form of acquisition, and
2. The intent of the parties in merging.

The form of acquisition is of no significance under Section 7. Purchases for cash and stock acquisitions are equally within the coverage of the Act. The one exception to this statement about form relates to acquisitions in which the acquired or the acquiring company is not a corporation since the statute is in terms of corporations. As to the intent of the parties, the fact that it is not their objective to decrease competition is of no significance. It is the probable effects of the combination that govern legality under Section 7.

Since the probable effects upon competition are the standard by which the enforcement agencies and the courts determine legality of a merger or acquisition the only way of anticipating the likelihood of Section 7 trouble is to consider what the probable effects of the merger will be. The very broad wording of Section 7 is such that there is no simple "acid test." Instead, the company embarked on a merger program must simply consider all the factors likely to be considered relevant and make an informed business judgment. This can only be done by examining the markets involved, the companies involved, and the likely impact of the merger of those companies in the markets.

Characterizing The Market

Conglomerate mergers under Section 7 are such an ill-defined problem that they will be disregarded for the purpose of this discussion. Therefore, the relevant market for the purpose of Section 7, and the market to be examined, is that market in which one of the two merging companies sells or could sell to the other, in the case of a vertical acquisition, or that market in which both companies sell in the case of a horizontal acquisition. This market thus defined must be examined for competitiveness before the merger and for the likely state of competition after the merger. The following topics are of interest:

1. Products, including products or services that are different in type but can be substituted for one another by the same types of users.

2. Numbers of competitors in the market as defined in geographic and product terms.

3. Characteristics of competitors including their dollar and unit sales, individual strengths, and individual trends.

4. Geographic limits on the market including trends from regional to national or interregional competition.

5. Economic health of the industry and the companies making it up with particular consideration of dropouts and market entrants.

6. Basis of competition whether price, quality, service, advertising, or other.

7. Manner in which prices in the industry are determined.

8. Marketing and distribution channels and methods.

9. Investment, technological skill, distribution channels, and other considerations effecting ease of entry into the business.

10. Extent to which the industry is integrated.

11. Technological content of the industry and rate of technological change.

12. Consolidation history of the industry.

13. Marketing and distribution patterns and their role in determining success or failure.

14. Total capacity of the industry and the relationship of capacity to demand.

15. The degree of maturity of the industry and trends in sales and profits.

The Combining Companies:

The market analysis provides the general basis for considering the degree of competitiveness of the industry and estimating whether competition is increasing or decreasing. The particular effects of a given merger or acquisition are dependent also upon the characteristics of the two companies involved. As to each of the companies, it is important to consider their present situations and any unusual competitive advantages that they would have if combined which are not available to them separately. The following information, at least, is of interest.

1. Market shares in dollars, units and percentages in products in the defined market.

2. Physical assets including the per cent of total industry capacity represented, the efficiency of plant, and the degree of obsolescence.

3. Over all financial strengths or weaknesses including financial power resulting from participation in markets or products other than those directly involved.

4. Marketing and distribution strengths including relationships with preferred channels of distribution and the role of advertising in sales.

5. Technological know-how and patent positions.

6. Identification of customers and suppliers, including their bargaining strengths and, in vertical acquisitions, the likelihood

of foreclosing important sources of supply or customers to others.

7. Geographic separation of the markets of combining companies, if any.

8. Rates of growth or decline of the companies absolutely and in relation to trends in the industry.

9. Past acquisitions of both companies, if any, with emphasis on acquisitions in the same industry.

It is not possible to say which of these factors is of the greatest importance since the probable effects of a merger will vary with the facts of the companies and the industry involved. Other factors such as intercorporate relations are sometimes of importance. In general, however, it may be said that the company embarking on a merger or acquisition program must use business judgment and the "feel" of the industry and address itself earnestly to the question that the businessman should be eminently qualified to answer: will this merger tend substantially to lessen competition in any line of commerce in any section of the country?

As part of its administrative procedure, the Department of Justice, upon request, will give an unofficial ruling or preliminary ruling on a proposed merger. This type of ruling is termed a "railroad release" in view of the fact that such a release was first used in connection with a request for merger clearance from a railroad company. Under this ruling the Department of Justice agrees not to criminally prosecute because of such merger activity. It should be remembered, though, that violations of section 7 of the Clayton Act are still subject to civil action.

Civil Aeronautics Board: The Civil Aeronautics Board has extensive authority to regulate the air transportation industry. Specific authority concerning the consolidation, merger, and acquisition or control of or by an air carrier is governed, in specified situations, by section 408 of the Federal Aviation Act of 1958. This section specifies that any person seeking approval of a consolidation,

merger, purchase, acquisition of control, etc., shall present an application to the Board. Although the Board has not prescribed any regulations for the processing of such an application, the proceedings are, in general, governed by Part 302 of the Procedural Regulations (Rules of Practice in Economic Proceedings).

Section 409 of the Federal Aviation Act concerns interlocking relationships. It is important in this connection because a merger may result in interlocking relationships which would require Board approval under section 409 of the Federal Aviation Act of 1958, as amended. Thus, if there existed interlocking relationships between either of the parties to the merger, on the one hand, and another company, on the other hand, which interlocking relationship had been approved by the Board, the merger would create new interlocking relationships between the resultant merged company and such other company, requiring Board approval under section 409. Approval of such interlocking relationships could be obtained in the proceeding during which approval of the merger or consolidation is sought. However, if a separate proceeding is utilized to obtain approval of the resulting interlocking relationships, the procedure set forth in Part 251 of the Board's Economic Regulations should be followed.

Comptroller of the Currency, Treasury Department: The Comptroller of the Currency is authorized and empowered to approve mergers and/or consolidations undertaken by any and all national banks. The statutes specifically concerning consolidation and mergers of national banks, either with State-chartered institutions or with other national banks, may be found in the Banking Act and the Federal Deposit Insurance Act. The administrative procedures concerning such consolidations may be found in 12 CFR 44.

Federal Communications Commission: The Federal Communications Commission, under authority of the Communications Act, regulates all interstate and foreign communication by wire and radio, including telegraph, telephone, and broadcast.

Companies under the jurisdiction of the Commission desiring to consolidate or merge with one or more companies, or to acquire the whole or any part of the property of another company by

purchase of securities, lease, or in any other like manner, must submit an application for authority to the Commission.

The general statutory provisions covering this activity are found in 47 U.S.C. sec. 214. Specific statutory provisions are contained in 47 U.S.C. sec. 221 for telephone companies, 47 U.S.C. 222 for telegraph companies, and 47 U.S.C. 310 for radio stations. Detailed regulations have also been promulgated under the statutory sections cited for each business segment—telephone, telegraph, and radio.

Federal Deposit Insurance Corporation: The Federal Deposit Insurance Corporation was created by the Banking Act of 1933 to provide insurance of bank deposits for its member banks. Banks admitted to insured status consist of deposit banks chartered as national banks in any State or in the District of Columbia, and State deposit banks which are admitted to the Federal Reserve System. National banks located outside of the States of the United States and the District of Columbia which are not members of the Federal Reserve System may become insured upon application by the bank and certification by the Comptroller of the Currency.

The Federal Deposit Insurance Corporation supervises all banks that have their deposits insured. Approval of this Corporation must be obtained before an insured bank (whatever its charter) may merge, consolidate, or assume the liabilities of any noninsured bank.

Specific statutory requirements concerning safeguards against mergers and consolidations of banks which might lessen competition unduly or tend unduly to create a monopoly in the field of banking are contained in the Federal Deposit Insurance Act. For pertinent regulations promulgated under authority of this Act see Title 12 Code of Federal Regulations, Chapter III.

Federal Home Loan Bank Board: The Federal Home Loan Bank Act was enacted for the purpose of setting up Home Loan Banks authorized to make loans to building and loan associations, mortgage companies, and savings banks on first mortgages of certain types held by them. The responsibility for the regulation of "Federal Savings and Loan Associations" was provided by the Home Owners Loan Act. The Board, by authority of this Act, un-

der such rules and regulations as it may prescribe, provides for the organization, incorporation, examination, operation, and regulation of such associations.

All Federal savings and loan associations and other insured institutions must submit for consideration and approval by the Board applications for consolidations, mergers, or the purchase of assets. In addition to the requirements concerning mergers, consolidations, etc., specified in the United States Code, specific regulatory requirements have been promulgated. These latter are found in 12 CFR 522.11-522.12, 12 CFR 563.16 and 563.22.

Federal Power Commission: The Federal Power Act and the Natural Gas Act provide the Federal Power Commission with: (1) authority over the interstate transmission of electric energy and public-utility companies engaged therein, and (2) the power to regulate the transportation and sale of natural gas in interstate commerce.

With respect to electric power, the Federal Power Commission passes upon applications in which public utility companies engaged in the sale of electric energy in interstate commerce request authority to issue securities; to dispose of, merge, or consolidate facilities; to interconnect facilities; or to acquire securities of other public utilities.

With respect to natural gas, the Federal Power Commission studies and evaluates applications for—and when required by public convenience and necessity, issues certificates authorizing—the construction, extension, acquisition, or operation of facilities for the transportation, sale, or resale of natural gas in interstate commerce.

Specific authority over the transfer of facilities by sale or merger and over the acquisition of securities of one company by another is provided by sections 203 and 204 of the Federal Power Act. Section 10 of this act also deals with mergers, etc., in that it prohibits combinations, agreements, arrangements, or understandings—expressed or implied—to limit the output of electrical energy; to restrain trade; or to fix, maintain, or increase prices for electrical energy or service.

Specific authority concerning the extension of natural gas facilities is provided by Section 7 of the Natural Gas Act.

Federal Reserve System: The Federal system of banking was established by Act of Congress in 1913 to provide supervision over banking. The Federal Reserve Act consequently divided the United States into twelve districts, each of which contains a Federal Reserve Bank. Collectively these twelve District Reserve Banks are under the supervision of a board of seven governors. The member banks of each of the Federal Reserve Banks consist of all the National Banks and such of the State Banks as choose to join the Federal Reserve System.

In addition to the authority provided by the Federal Reserve Act, authority with respect to bank mergers and/or consolidations is provided by the Bank Holding Company Act and the Federal Deposit Insurance Act. Under the Bank Holding Company Act, acquisition of bank stocks by bank holding companies is required, with certain exceptions, to have prior approval of the Board of Governors.

Under section 18(c) of the Federal Deposit Insurance Act, bank mergers and consolidations require the prior approval of the Board of Governors if the resulting bank is to be a State member bank of the Federal Reserve System. The Board has issued no regulations under this provision.

Federal Trade Commission: The Federal Trade Commission is charged with the responsibility for administering and enforcing antitrust and trade-regulation laws. A primary purpose of the laws which the Commission administers is to insure competition in our private-enterprise economy. They deal with prevention of monopoly, restraints of trade, and unfair trade practices.

One of the most important laws enforced by the Federal Trade Commission is section 7 of the Clayton Act,[1] as amended, otherwise known as the Antimerger law.

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[1] Pertinent sections of this Act are included in the portion of this book dealing with the Antitrust Division, Department of Justice.

This statute provides specific legislation on the subject of suppression of competition through the merger or consolidation of corporations. Merger or consolidation, whether brought about by the direct or indirect acquisition of either stock or assets of the acquired corporation, is prohibited when the acquisition or merger substantially lessens competition or tends to create a monopoly in any line of commerce in any section of the country.[2] Certain situations are excepted, including cases in which the stock is purchased solely as an investment, and is not used for voting or otherwise bringing about or attempting to bring about the substantial lessening of competition. The Commission is designated as having enforcement responsibility for commercial enterprises generally, but not for businesses which are specifically under the regulatory authority of other agencies.

Specifically excluded from the jurisdiction of the Federal Trade Commission under this and other sections of the Clayton Act are certain types of commercial enterprises subject to other regulatory authority, such as common carriers, air carriers, banks, banking associations, and trust companies.

There is no legal requirement that the Commission be notified of corporate mergers or acquisitions either before or after consummation. Premerger notification has been the subject of several bills in both Houses of Congress. Except in instances where a complaint about a particular merger is received, or where premerger consideration is requested, the Commission must rely on financial newspapers, trade journals, manuals of investments, and the like for information that a merger has occurred or is contemplated. A sheet containing such information as is readily available from press reports and recognized reference manuals is prepared for each merger. These are then referred to project attorneys who examine the information and consult with economists and other experts with respect to each merger. The project attorneys then determine the probable competitive effects and recommend whether or not further investigations should be undertaken.

If the preliminary review indicates the merger is one which

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[2] For the acquisition of stock in a Stock Export Trade Corporation, see requirements of the Export Trade Act.

may result in the adverse effects proscribed by the statute, a more comprehensive investigation is undertaken. This may be initiated by letters requesting the parties to submit detailed information concerning the companies and industry or industries involved, or by sending the matter to one of the Commission's branch offices where officials of the merging companies can be interviewed. The data obtained from the companies involved usually are supplemented by data obtained from other sources including: competitors, suppliers, and customers of the merging companies; trade associations; and government agencies. Investigations of this type, requiring as they do considerable economic and marketing analysis work, are generally more complicated, time-consuming, and expensive than are investigations under other statutes administered by the Commission.

Under the Commission's premerger clearance procedure, interested parties may request advice of the Commission concerning a proposed merger or acquisition. Facts relating to the proposed transaction may be submitted in writing or in conference. On the basis of these facts, as well as other information available to the Commission, the parties are informed whether consummation of the merger is likely to lead to further action by the Commission. Numerous conferences between members of the Bureau's staff and parties contemplating a merger are held each year.

In all restraint-of-trade matters, close liaison is maintained with the Antitrust Division of the Department of Justice in order to eliminate conflict or duplication of effort on those matters over which the two agencies may possess concurrent jurisdiction.

Internal Revenue Service: The Internal Revenue Service has no administrative responsibility in connection with acquisitions. It is concerned solely with the tax consequences involved.

The various sections of the Internal Revenue Code that are most pertinent to acquisitions in general are discussed in detail in that section of this book covering "The Tax View."

Interstate Commerce Commission: The Interstate Commerce Commission has authority over interstate and foreign transportation by express companies, pipelines (excepting water and gas), sleeping cars, motor carriers, bridges, ferries, car floats and lighters,

freight forwarders, and all terminal and transportation facilities used for or necessary in the interstate transportation of persons or property.

Jurisdiction over the consolidation or merger of two or more carriers operating in interstate or foreign commerce is conferred upon the Commission by the provisions of section 5 of the Interstate Commerce Act. This section requires any carrier or carriers desiring to engage in an acquisition to obtain authority therefor by submitting an application to the Commission.

The Commission's usual procedure when considering any such acquisition application is to notify the Governor of each state in which the carriers involved have property and any other interested parties. In passing upon any proposed acquisition, the Commission gives weight to many factors, including the effect the proposed acquisition will have upon the transportation service provided to the public. As a condition of its approval, in the case of railroads, the Commission requires a fair and equitable arrangement to protect the interests of the railroad employees affected.

Securities and Exchange Commission: The Securities and Exchange Commission administers a number of Federal statutes which are concerned to some extent with merger and/or consolidation activity. The most notable among them are discussed below:

a. *Securities Act of 1933*

This Act is designed to provide a full and fair disclosure to investors of material facts concerning the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof.

Disclosure under the Securities Act is accomplished in a two-step process: 1) by filing a statement concerning certain required financial and other data with the Commission; and, 2) by making a prospectus—containing all facts needed for an appraisal of the company's operations and an evaluation of its securities—available to purchasers and to investors. The prospectus must contain information with respect to:

1. the character, size, and profitableness of the business.

2. the capitalization of the issuer.

3. the purpose of the proposed offering of securities and the use to which the proceeds are to be applied.

4. the outstanding options for the purchase of securities of the issuer.

5. the remuneration of officers and directors, including bonus and profit-sharing arrangements.

6. the contractual or other arrangements with management officials or other affiliated interests.

7. the pending or threatened legal proceedings.

8. the underwriting and other terms of the offering.

The prospectus must include a balance sheet and three-year earnings statement, certified by an independent public accountant.

If securities are publicly offered and sold during the acquisition or disposition of a business, the registration and prospectus provisions must be complied with. When securities are to be issued under some other procedure, the issuance must come under one of the exemptions in the Act or under the regulations promulgated in the Act. An important exemption is the Securities and Exchange Commission Rule 133. This rule provides, in general, that: for the purpose of determining the application of the registration and prospectus provisions of Section 5 of the Securities Act, no "offer" or "sale" shall be deemed to be involved so far as stockholders of a corporation are concerned, where, pursuant to statutory provisions in the state of incorporation or provisions con-

tained in the certificate of incorporation, there is submitted to the vote of such stockholders a plan or agreement for a statutory merger, consolidation, reclassification of securities, or a proposal for the transfer of the issuance of securities of such other person or voting stock of a corporation which is in control, as defined in section 368(c) of the Internal Revenue Code of 1954.

Under certain circumstances, securities distributed by persons receiving them in connection with such transactions may have to be registered under the Act. For example, where one company is merged into another company, a stockholder in control of the merged company who receives securities of the surviving company with the intention of distributing them to the public shall be deemed to be an underwriter, and registration of the securities is required before the distribution can be made. However, registration is not required with respect to securities sold in certain brokers' transactions as defined in the rule.

There may be situations where the provisions of Rule 133 may not be applicable: for example, in an exchange of stock for stock where one corporation offers a voluntary exchange of its securities for all the outstanding securities of another corporation. In this situation, registration of the exchange may be necessary under the Securities Act on Form S-1 unless an exemption under the Act is available.

Form S-14 was adopted for the registration of certain securities issued in a Rule 133 transaction. This form is designed to provide a simplified registration procedure for securities issued in a Rule 133 transaction where such registration is required and where the issuer has solicited proxies under the Commission's proxy rules with respect to such transaction. The form provides that the prospectus may consist chiefly of the information set forth in the proxy statement, supplemented by the necessary underwriting and distribution data and pertinent information regarding developments in the registrant's business subsequent to the Rule 133 transaction. In effect, a listed company is permitted to utilize the proxy statement as the registration prospectus, provided the statement contains the required information.

Other exemptions from registration which may be available are provided by:

1. Section 3(a) (10) of the Act. Under this section, a transaction is exempt where the terms and conditions of the issuance and exchange of securities are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to offer the exchange shall have the right to appear, by any court or by any officer or agency of the United States or by any state or territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

2. Section 3(a) (11) of the Act. Under this section, a transaction is exempt where the security is a part of an issue offered and sold to persons resident within a single State, where the issuer of such security is incorporated by and transacts substantially all his business in said State.[3] If the scope of the offering is limited, an exemption from the registration provisions under the second clause under Section 4 (1) may be available as a transaction not involving a public offering of securities.

3. Another important exemption in regard to the registration of small issues is found in section 3(b) of the Securities Act. Under this section, the Commission is empowered to exempt—by its rules and regulations and subject to such terms and conditions as it may prescribe therein—any class of securities from registration under the Act. It may do this if it finds that enforcement of the registration provisions of the Act with respect to such securities is not necessarily in the public interest. It may also do this to protect investors when a small amount is involved or the character of the public offering is limited. The statute imposes a maximum limitation of $300,000 upon the size of the issues which may be exempted by the Commission in the exercise of this power.

Acting under this authority the Commission has adopted the following exemptive regulations:

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[3]Not withstanding the fact that the aforementioned transactions may be excluded from the registration provisions of the Act, the antifraud provisions of Sections 12 and 17 are still applicable.

Regulation A:
General exemption for United States and Canadian issues to $300,000.

Regulation A-M:
Special exemption for assessable shares of stock of mining companies up to $100,000.

Regulation A-R:
Special exemption for first lien notes up to $100,000.

Regulation B:
Exemption for fractional undivided interests in oil or gas rights up to $100,000.

Regulation B-T:
Exemption for interests in oil royalty trusts or similar types of trusts or unincorporated association up to $100,000.

Regulation F:
Exemption for assessments on assessable stock and for assessable stock offered or sold to realize amount of assessment thereon, up to $300,000.

b. *Securities Exchange Act of 1934*

This act provides for the registration and regulation of securities exchanges and for the registration of securities listed on such exchanges. In addition, it establishes financial and other reporting requirements for issuers of securities so registered, regulates proxy solicitations, and sets requirements for trading by directors, officers, and principal security holders.

Once securities are registered, the original registration suffices for any and all additional securities of the same class that the company may issue at a later date. Thus, if new securities are to be offered in connection with an acquisition, no registration is neces-

sary under the Securities Exchange Act of 1934, but a listing application must be filed for the additional shares. Certain sections and rules of the Securities Exchange Act of 1934 are definitely applicable to mergers and consolidations. If the securities of any of the corporations involved are registered and listed on a national securities exchange, Section 12 of the Act and Rule 12a-5 may be applicable. Also, if a company having a voting security listed on a stock exchange solicits the holders of these securities for their proxies or consents with respect to acquisition or disposition of a business, or some person or group solicits their opposition to the same, the persons soliciting must comply with the proxy requirements of the Commission under Section 14 (a) of the Exchange Act.[4] In addition, if any one of the corporations involved in the merger or consolidation is subject to the reporting requirements of section 13 or section 15(d) of the Act and the rules thereunder, a report of the transaction may be required on forms 10Ic or 8.1c. Furthermore, reports by officers, directors, or principal security holders may be required on Forms 4, 5, and 6 under sec. 16 (a) of the Act.

In this connection, the short swing recovery provisions of Section 16b of the Act (15 U.S.C. 78p(b)) may also be applicable. This section provides that any profits made on the sale or purchase of listed securities held for less than six months by insiders of the corporation inure to the benefit of the corporation.

c. *Public Utility Holding Company Act of 1935*

This act provides for the regulation by the Commission of interstate public utility holding company systems engaged in the electric utility business or in the retail distribution of gas. Sections 9 through 12 require proposed mergers or consolidations to be submitted to the Commission for approval or report.

d. *Trust Indenture Act of 1939*

Bonds, notes, debentures, and similar securities publicly offered for sale, except as specifically exempted by the Trust

[4] Also Section 12 (e) of the Public Utility Holding Company Act of 1935 and sec. 20 (a) of the Investment Company Act of 1940.

Indenture Act of 1935, must be issued under an indenture which meets the requirements of the Act and has been duly qualified by the Commission. If the issuance of debt securities is involved in a merger or consolidation, qualification of the indenture may be necessary under the Trust Indenture Act of 1939 unless an exemption provided by Section 304 of the Act is applicable.

APPENDIX B

The hypothetical balance sheets of Seller and Buyer with accompanying *pro forma* information illustrate in general terms the accounting difference in a pooling of interest when: (a) the stated or par value of stock issued is in excess of the stated or par value of stock of constituents, and (b) the stated or par value of stock issued is less than the stated or par value of stock of constituents—reference to issuance contemplates a pooling of interest effected by one of the parties issuing its stock for stocks of other constituents.

Also illustrated is the accounting difference in a purchase when: (a) the fair value of capital stock issued exceeds the book value of net assets received, and (b) fair value of stock issued is less than the book value of net assets received.

Excess of Par Value of Stock Issued Over the Par Value of Stock Exchanged
Basis of Combination

An increase of 70,000 shares of common stock of Company "B" issued on the basis of 2.8 shares of common stock for each share of Company "S" stock out.

Par value of stock issued...	$70,000
Par value of stock exchanged	25,000
Charged to Capital Surplus..	$45,000

Balance Sheet *Assets*	Company "B"	Company "S"	Pro Forma Adjustments†	Pro Forma Combined
		(thousands)		
Current Assets				
Cash	$ 794	$ 227		$ 1,021
Notes and accounts receivable	4,581	1,102		5,683
Inventories	5,091	612		5,703
Total Current Assets	10,466	1,941		12,407
Property, plant and equipment	3,381	220		3,601
Less accumulated depreciation	42	15		57
	3,339	205		3,544
	$13,805	$2,146		$15,951
Liabilities and Capital				
Current Liabilities				
Notes payable	$ 4,443	$ 802		$ 5,245
Accounts payable	2,259	481		2,740
Total Current Liabilities	6,702	1,283		7,985
Long Term Debt	700			700
Capital				
Capital Stock				
Preferred ($20. par value)	2,511			2,511
Common ($1.00 par value)		25	(25)	
Common ($1.00 par value)	646		70	716
Capital Surplus	706		(45)	661
Earned Surplus	2,540	838		3,378
	6,403	863		7,266
	$13,805	$2,146		$15,951

†The excess of the par value of the common stock issued over the par value of the common stock exchanged is chargeable to capital surplus on the books of either company. If such capital surplus did not exist this difference would be charged to earned surplus.

ILLUSTRATION II—POOLING OF INTEREST

Par Value of Capital Stock Issued Less than the Par Value of Stock Exchanged

Basis of Combination

An increase of 500,000 shares of common stock of Company "B" issued on the basis of one share for every ten shares of Company "S" common stock outstanding.

Par Value of stock exchanged	$5,000,000
Par Value of stock issued	500,000
Credited to Capital Surplus	$4,500,000

Balance Sheet	Company "B"	Company "S"	Pro Forma Adjustments†	Pro Forma Combined
Assets		*(thousands)*		
Current Assets				
Cash	$ 2,000			$ 2,000
Notes and accounts receivable	5,000	$1,700		6,700
Inventories	10,000	2,500		12,500
Total Current Assets	17,000	4,200		21,200
Property, plant and equipment	7,000	1,700		8,700
Less accumulated depreciation	3,000	900		3,900
	4,000	800		4,800
	$21,000	$5,000		$26,000
Liabilities and Capital				
Current Liabilities				
Notes payable	$ 9,000			$ 9,000
Accounts payable	1,000			1,000
Total Current Liabilities	10,000			10,000
Capital				
Capital Stock				
Preferred ($1.00 par value)	1,400			1,400
Common ($1.00 par value)	2,000	$5,000	($4,500)	2,500
Capital Surplus	1,600		4,500	6,100
Earned Surplus	6,000			6,000
	11,000	5,000		16,000
	$21,000	$5,000		$26,000

† The net book values at which Company "S" 's assets were stated was considered to approximate fair current values and, therefore, the excess of the fair market value of stock issued over book values of net assets acquired was attributed to goodwill. Such excess would first have been considered in the light of differences between book values and fair values of specific tangible and intangible assets

ILLUSTRATION III—PURCHASE

Excess of Fair Value of Stock Issued Over the Book Value of Net Assets Received

Basis of Combination

Company "B" acquired the capital stock of Company "S" in exchange for 750,000 shares of its common stock. The par value of the capital stock was $750,000 and its fair market value, at date of exchange, was $4,500,000.

Market value of stock given, $4,500,000. Book value of net assets received, $3,500,000. Included as goodwill, $1,000,000.

Balance Sheet	Company "B"	Company "S"	Pro Forma Adjustments†	Pro Forma Combined
Assets		*(thousands)*		
Current Assets				
Cash	$ 5,000	$ 850		$ 5,850
Notes and accounts receivable	9,000	1,000		10,000
Inventories	3,000	400		3,400
Total Current Assets	17,000	2,250		19,250
Property, plant and equipment	21,000	4,000		25,000
Less accumulated depreciation	12,000	2,250		14,250
	9,000	1,750		10,750
Goodwill			$1,000	1,000
	$26,000	$4,000	$1,000	$31,000
Liabilities and Capital				
Current Liabilities				
Notes payable	$ 1,000			$ 1,000
Accounts payable	4,000	$ 500		4,500
Total Current Liabilities	5,000	500		5,500
Long Term Debt	1,000			1,000
Capital—No. Shares outstanding				
Common Stock:				
	Before Acquisition / After Acquisition			
$2 par value	750,000	1,500	($1,500)	
$1 par value	10,000,000 / 10,750,000	10,000	750	10,750
Capital Surplus			3,750	3,750
Earned Surplus	10,000	2,000	(2,000)	10,000
	20,000	3,500	1,000	24,500
	$26,000	$4,000	$1,000	$31,000

† The net book values at which Company "S" assets were stated approximate fair current values and, therefore, the excess of fair market value of stock issued over book values of net assets acquired was attributed to goodwill. Such excess would first have been considered in the light of differences between book values and fair values of specific tangible and intangible assets.

ILLUSTRATION IV—PURCHASE

Book Value of Net Assets Received in Excess of the Fair Value of Stock Issued.

Basis of Combination

Company "B" acquired the capital stock of Company "S" in exchange for 750,000 shares of its common stock. The par value of the shares issued was $750,000 and its fair market value at date of exchange was $3,000,000.

Book value of assets received, $3,500,000. Market value of stock issued, $3,000,000. Difference, $500,000.

Balance Sheet	Company "B"	Company "S"	Pro Forma Adjustments†	Pro Forma Combined
Assets		*(thousands)*		
Current Assets				
Cash	$ 5,000	$ 850		$ 5,850
Notes and accounts receivable	9,000	1,000		10,000
Inventories	3,000	400		3,400
Total Current Assets	17,000	2,250		19,250
Property, plant and equipment	21,000	4,000		25,000
Less accumulated depreciation	12,000	2,250		14,250
	9,000	1,750		10,750
	$26,000	$4,000		$30,000
Liabilities and Capital				
Current Liabilities				
Notes payable	$ 1,000			$ 1,000
Accounts payable	4,000	$ 500		4,500
Total Current Liabilities	5,000	500		5,500
Long Term Debt	1,000			1,000
Excess of net assets of subsidiary acquired over value of consideration given			$ 500	500
Capital—No. Shares outstanding				
Common Stock:				
Before Acquisition / After Acquisition				
$2 par value 750,000		1,500	(1,500)	
$1 par value 10,000,000 / 10,750,000	10,000		750	10,750
Capital Surplus			2,250	2,250
Earned Surplus	10,000	2,000	(2,000)	10,000
	20,000	3,500	(500)	23,000
	$26,000	$4,000	—	$30,000

† The book value of net assets acquired approximate fair current value and the difference between the book value and the value of stock issued was accounted for as a deferred credit.

APPENDIX C

Check lists can be made for every phase of an acquisition program and little is served by attempting to include in this book examples of a variety. The combination digested as Appendix C provides both a "preliminary check" and a "detailed study."

These are used by one large industrial company. All of the detailed points to be studied are not shown here; an example of the detail is included in each list.

ACQUISITION CHECK LISTS

Introduction—Check lists are provided for each of the two study phases:

Preliminary Check

and

Detailed Study

Obviously, there is more leeway for inquiry and investigation

when owners of a prospective acquisition approach the buyers. In such cases the information sought in the *Preliminary Check* and the *Detailed Study* might normally be assembled quickly by one or two people.

On the other hand, investigation of a possible acquisition on B's own initiative demands utmost discretion during the *Preliminary Check.* In such cases, the range of inquiry may be limited to those parts of the *Preliminary Check* answerable without any contact or other action that would serve to disclose B's interest.

All information assembled will be submitted to the person designated as responsible for the acquisition study. Copies of such information will be provided only to those designated by the person responsible. While distribution of information will be restricted initially, extra copies of the Preliminary Check will be prepared in sufficient quantity to provide data to those who will make the Detailed Study, should such further study be approved. This will necessitate preparing copies for possible later distribution to those who will be concerned with the following aspects of the Detailed Study:

Sales and Marketing

Production and Engineering

Industrial Relations

Research

Legal and Corporate

Finance

Each check list indicates specific areas of inquiry or sources of information. Each lists *what is to be done,* rather than *who does what.*

Both the Preliminary Check and the Detailed Study will appear following the format used in the check lists.

Check List for Preliminary Check

NOTE: Designed to be performed by one or two people, who may provide data for more than one category. *For example:* the person doing the Production and Engineering check may also cover Industrial Relations, Research and Development and Finance. Similarly, the person doing the Sales and Marketing areas may also do the Legal and Corporate segment at this stage.

Report submitted will follow same outline format as used herein.

I. *General Data*

- A. Name and address of business
- B. Type of business
- C. Names of principals
  - (i) Officers and Directors, *or*
  - (ii) Owner(s)

    (Ref.: Standard & Poors
    Directory of Directors
    Dun & Bradstreet)
- D. History
  - (i) Date established
  - (ii) Where incorporated
  - (iii) Stage of development
  - (iv) Significant historical data
- E. Why available?

  or

  Why are we interested?
- F. What do we want to acquire?

II. *Sales and Marketing*

- A. Product end uses
- B. Areas served
- C. Distribution methods
- D. Seasonal aspects
- E. Market trends and penetration
- F. Patents (as indicated on products and labels)
- G. Customers' attitude
  - (i) Toward product(s)
  - (ii) Toward company

H. Innovations (or unique features) introduced
   (i) Products
   (ii) Marketing
   (iii) Customer service
I. Growth rate
J. Long-range commitments
   (i) To customers, including government agencies
   (ii) To vendors
      a. Rehandlers
      b. Applicators
      c. Contractors

NOTE: Point "J" may be impossible to answer unless we have been approached by the present owner.

(The details of the following sections are not shown to save space.)

III. *Production and Engineering*

(Basic raw materials, products produced, plant capacities, plant locations, etc.)

IV. *Industrial Relations*

(Unions, manpower availability, general industrial climate.)

V. *Research and Development*

(Quality and diversity of product lines vs. other producers, process evaluations, qualitative evaluation of R&D, patents, etc.)

VI. *Legal and Corporate*

(Primarily covered by other sections.)

VII. *Finance*

(Estimate of additional earnings vs. probable purchase cost, five-year financial history—company statements, if available, otherwise published earnings statements.)

Check List for Detailed Check

Report submitted will follow same outline format as used herein.

I. *General Data*

Recapitulation of data under "I" in *Preliminary Check.*

II. *Sales and Marketing*

A. History and future estimates of product line(s)
   (i) Dynamic or changing nature or line
   (ii) Services offered
   (iii) Latest innovations, or lack of innovations

B. Industry sales and profit trends
   (i) Past five years
   (ii) Five-year forecast

C. Seasonal factors
   (i) Effect on inventories
   (ii) Effect on sales prices

D. Industry's prevalent high-risk factors
   (i) Extent of contract activity
   (ii) Installation services
   (iii) Others peculiar to particular business

E. Evident changes that could accelerate obsolescence or affect profitability
   (i) Economic
   (ii) Technological
   (iii) Social
   (iv) Domestic
   (v) Foreign

F. Effect of industry capacity on selling prices
   (i) Past
   (ii) Present
   (iii) Estimate for future

G. Product line description
   (i) Product histories
   (ii) Data sheets
   (iii) Catalogues

H. Estimates of major product life-cycles
   (i) Those in development stage
   (ii) Those in introductory stage
   (iii) Profitability curve position
      a. Ascending on growth side
      b. On peak
      c. Descending with competitive pressure and obsolescence

I. Innovations
   (i) Products
   (ii) Merchandising plans

(iii) Sales methods
(iv) Installation or service
(iv) Add to

J. Effect of product line(s) on our lines
(i) Broaden
(ii) Supplement
(iii) Strengthen
(iv) Replace
(v) Add to

K. Customers
1. Major and general type
a. Majors identified—tabulate annual purchases and estimated future purchases
b. Areas where others are located—gross current and future purchase volume
2. Customer reaction to
a. Company—direct customer testimonials
b. Specific products and quality—direct customer testimonials
c. Service—direct customer testimonials

NOTE: Objectivity is vital. Use of outside consultant may be justified.

L. Distribution channels vs. our channels
(i) Supplement
(ii) Replace
(iii) Conflict with our current distributors, dealers, applicators, franchised contractors or rehandlers

M. Are there renegotiation liabilities?

N. Can our present salesmen and product staffs handle?
(i) How many new salesmen needed?
(ii) How many staff men needed?
(iii) What marketing changes are indicated?

O. Untried markets
(i) Where?
(ii) Should they be tapped?

P. Comparative five-year history and five-year forecast of sales and gross profit by product line
(i) Vs. our present growth products
(ii) Vs. our products approaching replacement

Q. Product line price trends
(i) Past five years

(ii) Five-year forecast

R. Review and evaluate
   (i) Sales management
      a. Headquarters
      b. Field
   (ii) Product management
   (iii) Field sales force
      a. Performance
      b. Compensation
      c. Turnover
      d. Sales training
   (iv) Sales organization
      a. Plan
      b. Operating procedures
   (v) Sales policies

S. Review and evaluate advertising and promotion policies and programs
   (i) Objectives
   (ii) Methods
   (iii) Principal budget elements
   (iv) Organization
   (v) Personnel
   (vi) Advertising agency

T. Determine sales expense ratio and advertising-promotion ratio for acquired company *plus* ours
   (i) Consider marginal selling cost of added sales
   (ii) Consider marginal advertising cost of added sales

U. Product lines and market penetration
   (i) Tabulation of products offered by *each* major competitor for various end uses and markets vs. combined products of acquired company and ours to establish basis for reliable forecasting
   (ii) Tabulate, based on comparative product line strength, past five-year actual and forecasted five-year sales and percentages of total market by product line for each major competitor vs. combined acquired company and us

(The details for each of the major headings are again not shown to save space. In general, the details studied at this stage are those which could not be available until the company to be acquired had agreed to the study.)

APPENDIX D

General Growth, Inc.
A. B. Dee, Inc.

Tentative Timetable for Proposed Merger

Prior to May 15

1. Apply for ruling as to tax-free nature of transaction.
2. Apply for ruling as to preferred stock "bailout" tax provisions.
3. Apply to SEC for ruling as to exemption of transaction under Securities Act of 1933.
4. Complete "Blue Sky" memorandum.
5. Ascertain necessity for approval by Massachusetts D.P.U. of stock options to be assumed or issued by GENERAL GROWTH.
6. Circulate questionnaires among officers and directors of GENERAL GROWTH and A. B. DEE respectively.

Prior to June 1

1. Obtain all necessary consents to merger such as Abernathy, American Industry, First National Bank of New York (holders of GENERAL GROWTH notes).

2. Obtain approval of proper authorities in Massachusetts and Wisconsin of proposed form of Agreement of Merger (Amendment—Articles of Consolidation).

June 2

1. First publication of A. B. DEE, INC., notice.

June 9

1. Meeting of GENERAL GROWTH board of directors to
   a. approve the Agreement of Merger (Amendment—Articles of Consolidation), authorize the execution. Therefore its submission to stockholders and, subject to stockholder approval, certification and filing thereof;
   b. approve "house-keeping" agreement (collateral agreement) and execution thereof;
   c. call, fix July 8 as record date and appoint proxy committee for, Special Meeting of Stockholders of GENERAL GROWTH to be held on August 14 to approve the merger;
   d. approve president's preliminary letter to stockholders, notice, form of proxy and Explanatory Statement for Special Meeting of Stockholders;
   e. appoint Transfer Agent for new Preferred Stock (who will also be Exchange Agent) and Script Agent, approve Memorandum of Instructions to Exchange Agent, new Preferred Transfer Agent and Script Agent;
   f. approve three new stock certificates (and legend for use on present supply of certificates);
   g. direct present Transfer Agents to use new certificates after merger;
   h. authorize issuance of new preferred stock and certificates therefor, upon effectiveness of the merger;
   i. authorize action, if any, required by "Blue Sky" laws;

j. authorize qualification to do business in additional states and appoint agents for service of process, upon consummation of the merger;
k. authorize amendments, if any, to Profit Sharing Retirement Plan and Incentive Compensation Plan;
l. ratify appointment of Rufus A. Wall to assist in soliciting proxies;
m. authorize officers and directors to take all necessary action to consummate the merger.

2. Meeting of A. B. DEE board of directors to
   a. approve Agreement of Merger (Amendment—Articles of Consolidation), authorize its execution, its submission to stockholders and, subject to stockholder approval, certification and filing thereof;
   b. approve "house-keeping" agreement and execution thereof;
   c. call, fix July 8 as record date and appoint proxy committee for Special Meeting of Stockholders of A. B. DEE to be held on August 14 to approve the merger;
   d. approve president's letter to stockholders, notice, form of proxy and Explanatory Statement for Special Meeting of Stockholders;
   e. terminate appointment of Transfer Agent upon effectiveness of merger;
   f. authorize transfer of bank accounts, funds, delivery of deeds and other property transfer documents, as required to GENERAL GROWTH upon consummation of the merger;
   g. authorize write-downs and new reserves; and
   h. authorize directors and officers to take all necessary action to consummate the merger.

3. Execution of Agreement of Merger by GENERAL GROWTH and A. B. DEE.

4. Joint press release issued by GENERAL GROWTH and A. B. DEE.

5. Release all material for printing.

6. Record date for stockholders' meetings of GENERAL

GROWTH and A. B. DEE.

7. Second publication of A. B. DEE, INC., notice.

July 10

1. Printer (GENERAL GROWTH) will have delivered proxies and mailing and return envelopes to Bankers Trust and American Industry.

2. Printer (A. B. DEE) will have delivered proxies and mailing and return envelopes to Racine National.

3. Release bank-note company on printing new stock certificates and over-printing present supply of stock certificates.

4. Commence "Blue Sky" registration and qualification, if necessary.

July 15

1. Printer (GENERAL GROWTH) will have delivered Explanatory Statements to Racine National, Bankers Trust and American Industry and letters and notices to Bankers Trust and American Industry.

2. Printer (A. B. DEE) will have delivered letters and notices to Racine National.

July 15-16

1. Mail notices of meeting, forms of proxies, prospectus and reply envelopes to GENERAL GROWTH and A. B. DEE stockholders.

July 15

1. Third publication of A. B. DEE, INC., notice.

July 22

1. Fourth publication of A. B. DEE, INC., notice.

2. Commence securing consents of other parties to assignment by A. B. DEE of its nonassignable contracts, leases, licenses, etc.

August 1

1. Mail reminder letter, if any, to GENERAL GROWTH and A. B. DEE stockholders.

August 6

1. Commence qualification of GENERAL GROWTH in states where A. B. DEE (but not GENERAL GROWTH) is presently qualified to do business.

August 14

1. Meeting of GENERAL GROWTH stockholders at Boston, Massachusetts.
2. Meeting of A. B. DEE stockholders at Racine, Wisconsin.

August 15-16

1. Certification of Agreement of Merger by clerk of GENERAL GROWTH and secretary of A. B. DEE and acknowledgement execution by officers of both.

2. Execution of Amendment—Articles of Consolidation by a majority of the boards of directors, the presidents and treasurers of GENERAL GROWTH and A. B. DEE respectively.

3. File duly executed Agreement of Merger in the office of the Secretary of State of the State of Wisconsin (effective date of merger).

4. Submit duly executed Amendment—Articles of Consolidation to Massachusetts Commissioner of Corporations and Taxation for certification; upon certification, file Amendment in the office of the State Secretary of the Commonwealth of Massachusetts (effective date of merger).

5. File Agreement of Merger in office of Clerk of Court of

County (Wisconsin) where A. B. DEE has original Certificate of Incorporation recorded.

6. File certified copy of Amendment—Articles of Consolidation and other qualifying papers, where required, in states where A. B. DEE is qualified to do business; and commence withdrawal of A. B. DEE in all states where qualified to do business which would require tax clearances and final tax payments.

7. Press release as to effectiveness of merger.

August 20

1. Mail letter regarding effectiveness of merger to GENERAL GROWTH and A. B. DEE stockholders (enclosing to the latter a form of transmittal letter).

2. Start exchange of certificates for GENERAL GROWTH Preferred Stock and Script for certificates for A. B. DEE Common Stock.

3. Closing under merger at which deeds, bills of sale, assignment of patents, trademarks, bank balances, contracts, leases, licenses, etc., will be delivered, if necessary.

4. Special meeting of GENERAL GROWTH board of directors to adopt bank resolutions and take other miscellaneous actions.

September 15

1. Last day for GENERAL GROWTH stockholders who voted against merger to make written demand for payment of their stock.

APPENDIX E

Announcement and Integration Agenda
Processing Inc. Acquisition
by
General Growth, Inc.

Offer:

1. General Growth, Inc. letter Friday, August 18 to Processing Inc. stockholders (Tender offer)

Press Announcement:

1. Initial press announcement of offer by General Growth (For release Monday, August 21)
2. Statement to Press by Processing president
3. Follow-up Press Announcement by General Growth
4. Announcement of completion of offer (For release Friday, A.M., August 25)

Employee Announcements:

1. Announcement (Friday, August 18) by General Growth

president to all General Growth Exempt Employees "Press release being put in mail today"
RE: offer to purchase

2. Letter (Monday, August 21) to Processing Employees by president of Processing on offer by General Growth. Follows meeting with exempt employees
   RE: offer to purchase. President of Processing recommends and is enthusiastic.
3. More personal letter (Monday, August 21) to key officials of Processing
4. Letter (September 1) to Processing employees by Processing president
   RE: Purchase accepted by tenders
   Copy of Annual Report General Growth included
5. Letter (September 4) by Processing division president
   RE: Now a Division of General Growth, Inc.
   No changes in titles
6. Letter (September 1) to key Processing employees
   RE: Invitation to Address by General Growth president on September 8
7. Agenda for Planning Meeting with top Processing management after meeting of board of Processing (September 8)
   RE: Setting areas of responsibility for General Growth and Processing Inc. in accomplishing orientation and familiarization.

Purpose of Meeting:

a. Review of responsibilities of principal executives General Growth and Processing Inc.
b. Set priorities of action
c. Set priorities of areas of review of operations
d. Set time schedules and plans for future meetings

APPENDIX F

Administrative Check List
Processing Inc. Acquisition
by
General Growth, Inc.
(Post Acquisition)

Personnel Listings

a. Exempt
b. Officers of subsidiaries—titles
c. Hourly, by location
d. Union contracts
e. Payroll points

Pension Arrangements

a. With key executives (special)
b. By plant or location
c. Contractual obligations
d. Voluntary arrangements subject to board of directors' discretion
e. Union contract provisions

Communication

a. Method of distribution
b. Correspondence to salesmen and licensees
c. Information copies to General Growth executives
d. Advertising agency and public relations
e. New York and plant contact

Assets (Special)

a. Real estate
b. Company dwellings
c. Surplus machinery
d. Cars and trucks

Leasing Arrangements

a. New York office space
b. Other sales offices
c. Office machinery

Meeting arrangements—Planning meetings
Sales solicitation
Capital expenditure handling

a. Pending capital expenditures by category

Reports

a. Open orders
b. Billings
c. Financial

Accounting check list and priorities
Advertising and public relations

APPENDIX G

Wilgrew—C—D Case

Wilgrew Corporation has been in business for many years; it is a diversified company manufacturing building materials, various industrial materials, and has a small asbestos mine in the U. S. which supplies some of its requirements for this raw material; it also has favorable contracts with a Canadian mine for balance of its requirements. While sales growth from 1947 to 1953 was at rate of 10% per year, there has been very little growth since. Moreover, the profit margin has been declining slowly and the return on investment has decreased. Cash had been depleted in 1952 by calling for redemption of the then outstanding $5,000,000 of 4% preferred stock, and it was necessary to do some borrowing from banks for the ensuing two years. It was thought advisable, in 1956, to offer 200,000 shares of common stock to stockholders—this was done to net the company $25.00 per share. This provided $5,000,000 additional cash for use in the program for expansion and acquisition.

A stock purchase and option plan was approved by the stockholders in 1951, following which the stock was put on a regular $1.00 dividend rate. The stock was widely distributed with no one

owning more than 2% of the outstanding stock. Statistical data for Wilgrew Corporation for the past eleven years are shown in the attached Table A.

Investigation of the company's position indicated that:

1. New products or businesses should be developed or acquired through merger.

2. The company should consider entering the pre-fabricated house field.

3. Some existing products were no longer profitable and should be studied with a view of either making them profitable or disposing of that portion of the business by sale or abandonment.

Early in 1959 business was improving and it appeared that its forecast of sales for the year 1959 of $98,000,000, with net earnings of $7,840,000 (8.00% of sales) was likely to be achieved. Table B shows the internal statement of earnings for 1957 and 1958.

Early in 1959 the Wilgrew Corporation learned about the C—D Company, manufacturers of certain types of building board, who had entered the shell home business in a small way, but with some success.

The C—D Company was reorganized about 1946, with two major stockholders, Messrs. John Compo and Harry Dole, each of whom owned about 40% of the stock, and each of whom bought half of the $2,000,000 of 7% preferred stock issued in 1946. At the end of 1953, as a first step in strengthening the financial position of the company, Messrs. Compo and Dole exchanged the $2,000,000 of 7% preferred for $1,000,000 of 6 % preferred and 40,000 shares of common stock which was valued at $25.00 per share. The two major stockholders then sold some of their holdings of common stock, listed the stock on the American Exchange, and announced that starting in 1955 a 4% stock dividend would be paid to preserve cash and yet give the stockholders some measure of the profit being secured.

The acquisition of a mine in 1954 added greatly to the com-

pany's earnings, by permitting them to mine rather than buy the raw material used in some of their building board. They also entered the pre-fabricated home field, building shell homes of components. The venture into shell homes increased inventories more than anticipated and required all the capital of the firm. Any further progress would require additional capital.

Late in 1956, Mr. Harry Dole died and his son, Mr. Chase Dole, was made executive vice president. Mr. Compo, president and chief executive officer, was approaching the age where he wanted to retire.

The Wilgrew Corporation had been selling the C—D Company about half of its requirements of asbestos board, amounting to about $400,000 per year, and the officials of the two companies were well acquainted. Mr. John Compo and Mrs. Harry Dole, now the other major stockholder, both thought that a merger with Wilgrew Corporation would provide them with safer retirement income.

In preliminary talks, the statistical data for the C—D Company (Table C) and statements of earnings for the past three years (Tables D and E) were given to officials of the Wilgrew Corporation in exchange for the information shown in Tables A and B. In April of 1959, the C—D Company stated that they were achieving their budgets for the first quarter of the year, and indicated that they should have sales for 1959 of $11,500,000 with an increase of earnings to $1,380,000 or 12% of sales, which would be close to the ratio achieved in 1955. However, they were badly in need of cash, and might have to borrow to get through the year. Preliminary conversations indicated that, on the basis of market value of stock ($25 for the C—D Company vs. $30 for the Wilgrew Corporation), the exchange rate would be 0.8+ shares of the Wilgrew Corporation for one share of the C—D Company, but on the basis of recent earnings the values appeared to be about equal.

Further investigation revealed, however, that if the operations of the C—D Company were brought to the same standards as used in the Wilgrew Corporation, and especially if the pension plan of Wilgrew Corporation were to apply to the employees of the C—D Company, earnings of the C—D Company would be reduced con-

siderably. Mrs. Harry Dole and Mr. Compo both agreed that they would wish their employees to benefit from the Wilgrew Corporation pension plan, and they opened their books and plant to inspection by officials of the Wilgrew Corporation.

Analysis indicated that to bring the C—D Company to the standards and accounting of the Wilgrew Corporation would require the following:

1. Inventory—Wilgrew used LIFO, and to adjust inventories of the C—D Company to the same LIFO basis would require added charges to cost of sales of $10,000 in the year 1958 and $20,000 per year for ten years to take care of the $200,000 overstatement of inventory.

2. Pensions—It was estimated that the supplemental payments necessary to take care of the fact that no accruals for a pension had been made would amount to $1,400,000 and could be taken as a charge to earnings over a ten-year period at the rate of $140,000 per year. Similarly, the current annual charge for pensions would amount to another $140,000 per year on the basis of 1958-1959 employees.

3. Working Conditions—The plant was found to be slightly sub-standard. Engineers estimated a capital expenditure of $200,000, which would add $40,000 per year to cost of sales, would be required to provide for depreciation and operating costs.

4. Research and Development—Management felt that the expenditures being made in this area were too low, particularly as one of the best researchers was underpaid and the company was in imminent danger of losing him. To correct this condition would add $30,000 per year to Research and Development Expense.

The total of these adjustments would result in a decrease of $380,000 per year in earnings before income taxes, or $200,000 per year in net profit, which would reduce 1958 net profit from $1,140,000 to $940,000. (See Table E) After this adjustment the value of the C—D Company, in the eyes of the officials of the Wilgrew Corporation, was greatly reduced. However, as they were anxious to get into the prefabricated home field and felt that this was a good opportunity to do so with minimum loss of time, they

instructed their chief engineer and controller to study the merger possibilities in greater depth.

Their study developed the following conclusions:

1. Economies of the merger—Through savings in methods and paper work and transfers to corporate headquarters, net savings of $80,000 per year were considered likely.

2. Purchases by the C—D Company from Wilgrew Corporation —The annual $400,000 purchase of material by the C—D Company could be treated as an interdivision transfer from plant to plant, thus eliminating expense of selling, handling orders in the district office, etc. Moreover, the C—D Company would buy all of this board from Wilgrew Corporation thus increasing sales by $400,000 and gross profit (at marginal costs) by $200,000.

In the consolidated statement of the two companies, sales would be decreased by $400,000 for the current business, while sales of the added business would also be eliminated in consolidation. Thus the Board Division of the Wilgrew Corporation which was selling this product would show a $400,000 increase in sales and a $200,000 increase in marginal cost; in consolidation $800,000 would be eliminated from both sales and cost, resulting in a decrease of $200,000 in consolidated cost.

3. With added capital, the operations of the C—D Company could be expanded into other territories which they were not now able to reach from their existing plant. It was estimated that the first such expansion would involve a capital expenditure for plant, equipment and added working capital of $2,000,000. This would result in added sales of $2,000,000 and added net profit of $384,000 in the first year and somewhat more in subsequent years. The increase in cash flow would be $544,000 per year.

4. Engineers found great opportunities for cost reduction in existing plant, particularly in the manufacture of panels. This would require an expenditure of $2,000,000. The added earnings from cost reduction were estimated conservatively at $800,000 per year, after added depreciation of $200,000, but before income taxes which were estimated to reduce this by $416,000. The added net profit was calculated to be $384,000 while the cash flow would amount to $584,000.

5. Examination of balance sheet items indicated that while cash was low, the inventories were higher than they need be, and accounts receivable were also too high, due to lack of aggressiveness in collections. While accounts were good and losses were low, the controller estimated that enough cash could be recovered from inventories and receivables to furnish working cash in adequate amounts for existing business.

The controller calculated that the added investment to be made after the merger would be $4,200,000 on which, at the Corporation's demanded rate of return of 14% after taxes, added earnings should be more than $588,000.

6. Investigation of other matter disclosed no bad features. The union which represented the C—D Company was the same one which represented employees of the Wilgrew Corporation in nearby plants. The sales forces seemed to be eager and aggressive and the field managers were rated more than adequate. The Wilgrew Corporation would be getting some very promising executive material in the young executive vice president of the C—D Company and the production manager, the general sales manager and the manager for technical research in the building component field.

On the basis of his figures, the controller estimated that added net earnings in 1960 should be based on sales for current operations of the C—D Company of $12,000,000 plus added sales of $2,000,000. Before adjustment, net profit for 1960 was $1,630,000 or 13.6% of sales, while the various adjustments would increase this figure by $680,000 to $2,310,000 or 16.5% of sales of $14,000,000 (see Table F). While consolidated sales would be decreased by $800,000, the consolidated net earnings of the two companies would be increased by $2,310,000 in 1960, following the merger, under the premises stated.

Using these figures the controller for the Wilgrew Corporation calculated net earnings per share and dividend payments on a *pro forma* basis after consolidation in 1960 as follows:

	Wilgrew Corporation		*The C—D Company*	
	Net Earnings		*Net Earnings*	
	(000)	*per share*	*(000)*	*per share*
Actual				
1958:—				
Before merger	$6,950	$1.92	$1,140	$1.81
Adjusted	6,950	1.92	940	1.49
1960 Forecast:—				
Without merger	8,400	2.31	1,630*	2.58
Adjusted			1,390*	2 20

* Provided additional capital is raised.

Estimated consolidated earnings after merger:

	Wilgrew Stockholders per share	*C—D Stockholders per original share*
1958 reconstructed and adjusted Consolidated N. E. $7,890,000		
If .8 ss W. for 1 ss C—D	1.91	1.53
If .9 ss W. for 1 ss C—D	1.88	1.67
If 1 ss W. for 1 ss C—D	1.85	1.85
1960 Forecast after merger Consolidated N. E. $10,710,000		
If .8 ss W. for 1 ss C—D	2.59	2.07
If .9 ss W. for 1 ss C—D	2.55	2.30
If 1 ss W. for 1 ss C—D	2.51	2 51
Dividends:		
Before merger	1.00	4% stock
After merger		
If .8 ss W. for 1 ss C—D	1.00	0.80
If .9 ss W. for 1 ss C—D	1.00	0.90
If 1 ss W. for 1 ss C—D	1.00	1.00

The controller summarized these figures by stating that, based on 1958 results adjusted to the Wilgrew Corporation accounting and standards, the consolidated net earnings would have been for Wilgrew stockholders:—

On the basis of .8 ss for 1	$1.91 per share
On the basis of .9 ss for 1	1.88 per share
On the basis of 1 for 1	1.85 per share

And that this compared with $1.92 actually achieved.

For the C—D Company stockholders, net earnings per original share held would have been in 1958:

On the basis of .8 for 1	$1.53 per share
On the basis of .9 for 1	1.67 per share
On the basis of 1 for 1	1.85 per share

All compared with $1.81 per share achieved, but $1.49 per share after adjustment to Wilgrew accounting and standards.

On the other hand, the comparison for Wilgrew Corporation was much improved when considering the possible results in 1960. The Wilgrew forecast estimated $2.31 without the merger. With the merger, earnings would be from $2.51 for a 1 for 1 deal, and $2.59 if .8 shares for 1 were given. Deducting the demanded earnings in the new investment would reduce these figures by less than 12¢ per share. The C—D Company stockholders, after accounting according to Wilgrew standards would have per share earnings of $2.20, if capital were available. With the merger, each share would earn $2.07 on a .8 for 1 basis, $2.30 if they received .9 ss for 1, and $2.51 on an even exchange. Similar forecasts prepared for years 1961 through 1964 showed increasingly better results.

Of the forecasted additional net earnings for 1960 of $2,310,000, the controller indicated $588,000 should be attributable to the added investment of $4,200,000 following the merger. The balance of $1,722,000 is equivalent to $2.73 per share of Wilgrew stock paid for C—D Company on a 1 for 1 basis, $3.03 per share paid on a .9 for 1 basis and $3.41 per share paid on a .8 for 1 basis. Even the $2.73 was more than the $2.31 Wilgrew expected without the merger. On the basis of these figures the officers of the Wilgrew Corporation felt that their maximum price should be 1 for 1, but that they should start dickering with a .8 for 1 offer. They planned to point out the following advantages to the C—D Company stockholders:

1. The C—D Company would be operated as a separate Division of the Wilgrew Corporation. The executive vice president of the C—D Company would be general manager of the Division. The president of the C—D Company would be made a director of the Wilgrew Corporation.

2. Earnings under the consolidation would compare favorably with those achieved before the merger.

3. After the merger, the Wilgrew Corporation would invest $4,200,000 cash in the C—D Division, and probably more later.

4. There would be greater growth of earnings and dividends under the merger than would be possible otherwise.

5. Employees of the C—D Company, including the executive vice president, would be brought under the pension plan of the Wilgrew Corporation. This would benefit many of the executives who were also stockholders of the C—D Company.

6. Stockholders of the C—D Company would start receiving cash dividends; selling the 4% stock dividend to secure cash meant dilution of their interest in the company.

7. Officials of the Wilgrew Corporation pointed out that on the basis of market value the .8 shares for 1 ratio was fair.

* . * *

The merger was finally concluded on the basis of 0.85 ss of Wilgrew Corporation stock for one share of the C—D Company stock.

WILGREW CORPORATION

TABLE A

Year	Sales (000)	Net Earnings			Investment—Book Value		Shares Outstanding (000)	Per Share				
		(000)	% Sales	% Investment	(000)	Per Share		Net Earnings	Dividends	Price Range High—Low	Price ÷ Earnings	Ave. Yield
1947	$46,000	$2,960	6.4%	14.6%	$21,029	$ 6.24	3,370	$0.82	$0.50	17.75 — 15.75	20	3.0%
1948	61,000	4,600	7.5	20.7	23,407	6.95	3,370	1.31	0.60	18.25 — 16.25	13	3.4
1949	55,000	3,960	7.2	16.3	25,145	7.46	3,370	1.12	0.60	16.5 — 15.5	14	3.8
1950	67,000	5,100	7.6	19.3	27,686	8.21	3,370	1.45	0.70	19 — 16	12	4.0
1951	72,200	7,150	9.9	24.0	31,940	9.48	3,370	2.06	0.80	23 — 18.25	10	3.9
1952	77,500	7,550	9.7	22.1	36,270	10.74	3,376	2.24	1.00	28.5 — 22	11	4.0
1953	83,200	8,340	10.0	21.5	41,480	12.25	3,386	2.46	1.00	31 — 28	12	3.4
1954	75,650	6,280	8.3	14.6	44,470	13.12	3,390	1.85	1.00	28.5 — 25	14	3.7
1955	82,300	6,710	8.2	14.5	48,080	14.14	3,402	1.97	1.00	28.5 — 26	14	3.7
1956	87,000	7,080	8.1	13.5	56,850	15.72	3,614	1.96	1.00	29 — 26½	14	3.6
1957	92,000	7,450	8.1	12.6	60,980	16.83	3,624	2.07	1.00	33.25 — 28.5	15	3.2
1958	89,000	6,950	7.8	11.2	63,450	17.49	3,630	1.92	1.00	33 — 28.5	15	3.3

NOTES: (1) Dividend of $200,000 per year paid in preferred through 1951.
(2) Stock option @ $25 per share taken by executives starting in 1956.
(3) 200,000 ss common stock sold in 1956 @ $25 per share.

WILGREW CORPORATION

TABLE B

	1957		1958	
	(000)	%	(000)	%
Sales, Net	92,000	100.0	89,000	100.0
Cost of Sales	62,000	67.4	60,180	67.6
Gross Profit	30,000	32.6	28,820	32.4
Operation Division Expense				
Field Sales	3,850	4.2	3,820	4.3
District Offices	2,850	3.1	2,800	3.1
Advertising	1,800	2.0	1,800	2.0
Research—Development	1,950	2.1	1,900	2.1
Administration	1,970	2.1	1,900	2.2
Total	12,420	13.5	12,220	13.7
Corporation Division Earnings	17,580	19.1	16,600	18.7
Corporate Expense				
Public Relations	710	.8	680	.8
Research General	760	.8	730	.8
Administration	3,230	3.5	3,130	3.5
Total	4,700	5.1	4,540	5.1
Other Income—Net	520	.6	440	.5
Earnings before Inc. Tax	13,400	14.6	12,500	14.1
Income Taxes	5,950	6.5	5,550	6.3
Net Earnings	7,450	8.1	6,950	7.8

TABLE C

THE C — D COMPANY

Year	Sales (000)	Net Earnings (000)	Net Earnings % Sales	Net Earnings % Investment	Investment—Book Value (000)	Investment—Book Value Per Share	Shares Outstanding (000)	Per Share Net Earnings	Per Share Dividends	Per Share Price Range High—Low	Price — Earnings	Ave. Yield
1947	NA	NA			$ 2,940	$ 5.88	500					
1948	$ 7,800	$ 360	4.6%	11.8%	3,160	6.32	500	$ .44				
1949	7,000	320	4.6	9.8	3,340	6.68	500	.36				
1950	8,000	500	6.2	14.2	3,700	7.40	500	.72				
1951	8,800	700	8.0	17.6	4,260	8.52	500	1.12				
1952	8,010	600	7.5	13.4	4,720	9.48	500	.92				
1953	9,060	750	8.3	14.9	5,330	10.66	500	1.22				
1954	10,200	1,110	10.9	17.4	7,380	13.67	540	1.94	0	30 — 26	14	0
1955	11,400	1,470	12.9	18.2	8,790	15.65	562	2.51	Stock 4%	33 — 23	11	0
1956	10,800	1,245	11.5	13.2	9,975	17.09	584	2.03	Stock 4%	25½ — 19½	11	0
1957	9,800	1,025	10.4	9.4	10,940	18.02	607	1.59	Stock 4%	21½ — 12½	11	0
1958	11,000	1,140	10.4	9.4	12,080	19.13	631	1.81	Stock 4%	25½ — 15½	11	0

NOTES: (1) Preferred stock outstanding from 1946 to end of 1953—$2,000,000 of 7% preferred callable at 100.
Preferred stock outstanding from end of 1953 to end of 1957—$1,000,000 of 6% preferred callable at 100.
Common stock—40,000 shares exchanged at end of 1953 (Jan. 1, 1954) for $1,000,000 of 7% preferred.
(2) $1,000,000 loan obtained at end of 1953 to use for purchase of mine. Paid off in 1955. Interest paid 6%.

TABLE D

THE C—D COMPANY

	1955		1956		1957	
	(000)	% Sales	(000)	% Sales	(000)	% Sales
Sales	$11,400	100.0	$10,800	100.0	$9,800	100.0
Cost of Sales	6,678	58.6	6,565	60.8	6,158	62.8
Gross Profit	4,722	41.4	4,235	39.2	3,642	37.2
Expense						
Field Selling	513	4.5	497	4.6	450	4.6
Area Offices	433	3.8	432	4.0	400	4.1
Advertising	330	2.9	335	3.1	323	3.3
Research & Development	220	1.9	220	2.0	207	2.1
Administration	456	4.0	471	4.4	402	4.1
Total	1,952	17.1	1,955	18.1	1,782	18.2
Interest Paid	60	.5				
Miscellaneous Income	100	.9	100	.9	100	1.0
Earnings before Taxes	2,810	24.6	2,380	22.0	1,960	20.0
Income Taxes	1,340	11.7	1,135	10.5	935	9.4
Net Profit	1,470	12.7	1,245	11.5	1,025	10.6
Depreciation & Depletion	390		403		420	
Cash Flow	1,860		1,648		1,440	

TABLE E

THE C—D COMPANY

1958 Earnings Adjusted to Wilgrew Standards

In thousands of dollars

	1958 Actual		Consolidation Adjustments To Bring Up to Wilgrew Standards						1958 Adjusted	
				(4) Pensions	(5)					
	(1) Dollars	(2) % Sales	(3) Inventory To LIFO (10 years)	Supplementary (10 years)	Annual	(6) Working Conditions	(7) Research	(8) Total	(9) Dollars	(10) % Sales
Sales	$11,000	100.0							$11,000	100.0
Cost of Sales	7,000	63.6	+30	+ 80	+ 80	+ 40		+230	7,230	65.7
Gross Profit	4,000	36.4	—30	— 80	— 80	— 40		—230	3,770	34.3
Expense										
Field Selling	505	4.6		+ 20	+ 20			+ 40	545	5.0
Area Offices	425	3.9		+ 15	+ 15			+ 30	455	4.1
Advertising	330	3.0							330	3.0
Research & Development	220	2.0		+ 9	+ 9		+30	+ 48	268	2.4
Administration	440	4.0		+ 16	+ 16			+ 32	472	4.3
Total	1,920	17.5		+ 60	+ 60		+30	+150	2,070	18.8
Other Income	100	.9							100	.9
Earnings Before Taxes	2,180	19.8	—30	—140	—140	— 40	—30	—380	1,800	16.4
Income Taxes	1,040	9.4						—180	860	7.8
Net Profit	1,140	10.4						—200	940	8.5
Depreciation & Depletion	440	4.0				+ 20		+ 20	460	4.1
Cash Flow	1,580	14.4						—180	1,400	12.7
Investment—end of year	12,080		—30					— 30	12,050	
Added Investment						+200		+200	+200	

TABLE F

THE C — D COMPANY

Added Earnings in 1960 from Purchase of the C — D Company

In thousands of dollars

	1960 F/C		Various Adjustments to Secure Added Earnings from Merger						
	Dollars	% Sales	To Bring to Standard Note 1	Economies of Merger	C-D Company Buying All Board from Wilgrew	Expansion	Cost Reduction	Total Adjustment Net	Added Net Earnings
Sales	$12,000	100.0				+2,000		+2,000	$14,000
Cost of Sales	6,924	57.7	+276	—10	—200	+1,000	—800[a]	+ 266	7,190
Gross Profit	5,076	42.3	—276	+10	+200	+1,000	+800	+1,734	6,810
Expense									
Field Selling	540	4.5	+ 48		— 32	+ 80		+ 96	
Area Offices	450	3.8	+ 36	—20	— 8	+ 60		+ 68	
Advertising	360	3.0		—10		+ 60		+ 50	
Research & Development	240	2.0	+ 58					+ 58	
Administration	480	4.0	+ 38	—40				— 2	
Expense Total	$2,070	17.3	+180	—70	— 40	+ 200		+ 270	$ 2,340
Miscellaneous Income	100	.9							100
Earnings before Taxes	3,106	25.9	—456	+80	+240	+ 800	+800	+1,464	4,570
Income Taxes	1,476	12.3	—136	+42	+126	+ 416	+416	+ 784	2,260
Net Profit	1,630	13.6	—240	+38	+114	+ 384	+384	+ 680	2,310
Depreciation & Depletion	440		+ 20			+ 160	+200	+ 380	820
Cash Flow	2,070		—180	+38	+114	+ 544	+584	+1,060	3,130
Added Investment			200			2,000	2,000	4,200	

Note 1.—Increased 20% to provide for 1960 operations.

[a] Net savings 1,200
Less added costs and depreciation —400
Net change in cost —800

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